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COMMUNICATIONS

Vojtěch Cepl	The Transformation of Hearts and Minds in Eastern Europe
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Economic Freedom, Prosperity, and Equality: A Survey

Steve H. Hanke and Stephen J. K. Walters

> The best thing a society can do to increase its prosperity is to wise up. This means, in turn, that it is very important that economists, inside government and out, get things right. When we are wrong, we do a lot of harm. When we are right—and have the clarity needed to prevail against the special interests and the quacks—we make an extraordinary contribution to the amelioration of poverty and the progress of humanity. The sums lost because the poor countries obtain only a fraction of . . . their economic potentials are measured in the trillions of dollars.
>
> —Mancur Olson

Economic growth is, quite literally, a matter of life and death. The relation between income growth and life expectancy is, of course, complex. Growth affects life expectancy through many channels: higher individual and national incomes produce favorable effects on nutrition, on standards of housing and sanitation, and on health and education expenditures. While it is true that reductions in mortality have sometimes been the result of "technological" factors, in the larger sense it is clear that sustained economic growth is a precondition for the kinds of investments and innovations that, over time, significantly reduce mortality. The evidence on this point is abundant and unequivocal (see, e.g., Schultz 1993).

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Figure 1 shows, in a crude way, the positive linkage between per capita income and life expectancy for a cross-section of countries. Note that the relationship is characterized by diminishing returns: given increments in income yield smaller and smaller gains in life expectancy (see Preston 1975).[1] Nevertheless, the potential gains in life expectancy in poorer countries are quite large. Based on the data shown in Figure 1, for example, increasing a representative country's per-capita annual income from, say, $500 to $1,000 might increase life expectancy in that country by over 6 percent—or 3 3/4 years.

It is for such reasons that policymakers and scholars have long been acutely interested in the process of economic development; indeed, interest even predates Adam Smith's publication of *An Inquiry into the Nature and Causes of the Wealth of Nations* in 1776. Unfortunately, the search for a recipe for growth often has overlooked some important ingredients.

In older models of economic growth, physical resources were all. In these formulations, output flowed from combinations of various inputs (land, labor, capital). In principle, then, it seemed logical to conclude that faster growth would result from infusions of additional inputs (chiefly capital) or better use of existing inputs (often thought to require centralized economic planning). In practice, however, such prescriptions often have been disastrous for less developed countries (see Bauer 1984). Newer ("endogenous growth") models have identified many other variables that contribute to differences in growth rates—e.g., knowledge spillovers resulting from increases in the stock of physical capital, technology transfers, and human capital investment. Yet even these sophisticated formulations often fail to explain observed patterns of development (see Olson 1996).

Most recently, however, some students of economic growth have returned to first principles. They have concluded that analysis of how markets operate may be a poor guide to how markets *develop* (see North 1990, 1994). They have focused on the nature of institutions and on the structure of rules and norms that constrain economic behavior as a way of understanding the development process. And they have rediscovered Smith's ancient insight that economic liberty is a crucial precondition for sustained, vigorous economic growth.

This is not to deny that abundant natural resources, a highly skilled labor force, and ready availability of new technologies may enhance growth. But these factors are neither necessary nor sufficient conditions for growth. If resource endowments determined a national econ-

[1]Because the relationship between income and life expectancy is nonlinear, the natural logarithm of each country's per-capita income is plotted on the horizontal axis in Figure 1.

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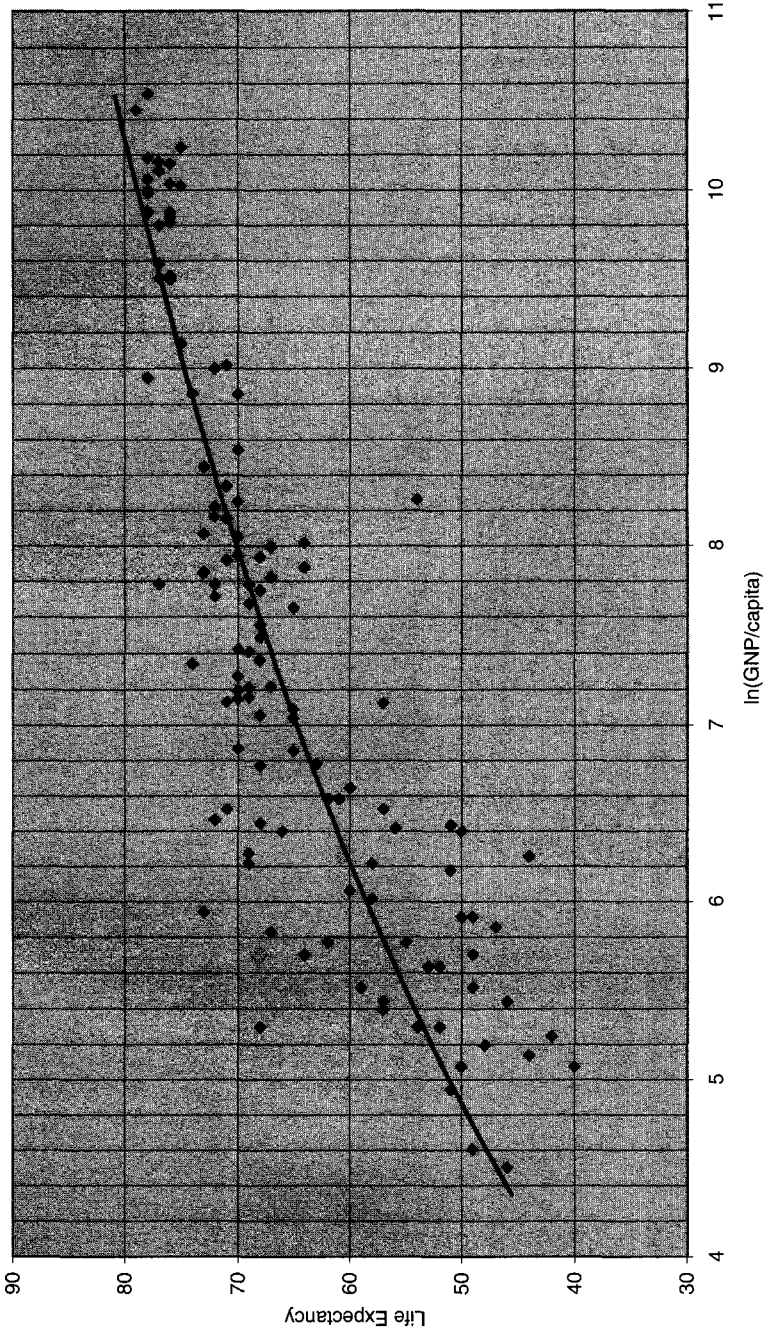
FIGURE 1

Prosperity and Longevity in 121 Countries



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omy's fate, Venezuela would be rich and Taiwan poor—and South Korea would be as destitute as North Korea. East Germany's highly skilled labor force should have enabled it to keep pace with West Germany before the Iron Curtain fell. And if access to sophisticated technology guaranteed prosperity, perhaps the Soviet Union would still exist.

As discussion of the linkage between economic liberty and economic growth has proceeded, there has been great interest in identifying the key components of economic liberty and, if possible, measuring it. That is the focus of this survey. In what follows, we will: (i) summarize the basic approaches to measuring economic liberty and discuss some of the methodological problems involved, (ii) identify the measurement efforts already undertaken and summarize their varying approaches to these problems, (iii) critically evaluate these measurement efforts, (iv) discuss the linkage between existing measures of economic liberty and crucial economic performance indicators such as income level and inequality, and (v) discuss the usefulness of these measures as guides for policy.

Before doing so, however, we should clarify some terms. Note first that economic liberty is distinct from political or civil liberty. By most accounts, political liberty is present when citizens are free to participate in the political process on an equitable basis, there is meaningful competition in the political sphere, and elections are free and fair. Civil liberties include protection against unreasonable searches, access to fair trials, and rights of free assembly, expression, and practice of religion.

While such political and civil liberties may go hand in hand with economic liberties, we must also recognize that a country may be "free" or "democratic" in a civil or political sense, but lack economic freedom. At the same time, a country may lack political or civil liberties, yet possess abundant economic freedom. In this survey, we focus on economic liberty not because other liberties are unimportant, but simply because there is no conclusive evidence that they are preconditions for economic growth (see Przeworski and Limongi 1993).

Though scholars have yet to agree on a single, operational definition of economic liberty, there appears to be wide agreement on its central elements (see Rabushka 1991):

- Secure rights to property (legally acquired);
- Freedom to engage in voluntary transactions, inside and outside a nation's borders;

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- Freedom from governmental control of the terms on which individuals transact; and
- Freedom from governmental expropriation of property (e.g., by confiscatory taxation or unanticipated inflation).

Clearly, these elements prescribe an important but balanced role for government. The institutions of government will create and enhance economic freedom by making and enforcing rules governing behavior in the economic sphere—e.g., by preventing Paul from stealing Peter's property. But government might also diminish economic freedom by itself robbing Peter, whether to pay Paul or achieve some other objective. Of course, reasonable people will differ about what constitutes a "balanced role" for government, and this will make the task of measuring economic liberty more difficult, as we shall see.

Measuring Economic Liberty: Basic Approaches and Problems

Unlike a country's Gross Domestic Product or a candidate's vote totals, economic liberty cannot simply be counted. Freedom is a quality rather than a quantity. In consequence, a certain amount of subjectivity and imprecision will be inevitable in any attempts to measure economic freedom.

This is why most such attempts have produced rankings of countries according to the amounts of economic liberty present, rather than numerical measurements of these amounts. (In economics jargon, the focus is on "ordinal" rather than "cardinal" measures of freedom.) In effect, students of economic liberty are far more comfortable saying, e.g., "Switzerland is more economically free than Somalia" than saying "Switzerland contains 10.0 units of economic freedom while Somalia contains 0.5." Of course, the process of ranking countries may involve calculating liberty "scores" by some method, but no one, to our knowledge, has yet suggested such scores mean that "Switzerland is 20 times freer than Somalia."

There are infinitely many ways to develop such rankings (and/or calculate such scores). Perhaps the simplest way is via an opinion poll: ask a knowledgeable sample of individuals to rank countries based their perceptions of the degree of economic freedom present therein. The resulting individual rankings can be averaged to produce a "consensus ranking" of the sample.

On the surface, this method would appear to involve very high degrees of subjectivity and imprecision. No matter how carefully chosen is the sample of knowledgeable individuals, there will be variance in the degree of their expertise across countries, the factors

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they consider important in determining economic freedom, and the relative weights they attach to these factors in devising their rankings.

The desire to minimize such variance and to produce more objective and precise rankings has led to several alternative approaches that—at least on the surface—appear more sophisticated. In general, these efforts involve (a) identification of the crucial elements of economic liberty, (b) quantification of these elements, and (c) weighting these elements in some way so that a liberty index or score may be calculated for ranking purposes.

Note, however, that many crucial elements of economic liberty may not be observable or readily quantifiable, requiring the use of various "proxies" for these elements. These proxies may mirror the underlying element of liberty with some distortion. For example, we may decide that the absence of barriers to international exchange is an important element of economic liberty. Tariffs are one such barrier. In consequence, we may choose to measure this element of liberty with a discrete variable (e.g., zero if tariffs exist or exceed some threshold, one if not), a continuous variable (e.g., the average tariff rate), or some combination of variables. Our choice of proxies may crucially affect the resulting scores and rankings.

The weights attached to each element (or proxy) will do the same. We may decide, for example, that freedom of international exchange and freedom of domestic exchange are both crucial elements of economic liberty. But is one more important than the other? Which? Consider countries *X* and *Y*. *X* imposes immense barriers to international trade, but has no restrictions on domestic commerce, while *Y* has moderate barriers both internationally and domestically. Clearly, if we give great weight to international trade barriers in devising a liberty index or score, *X* will rank below *Y*. But can we say with confidence that individuals in *X* have less economic freedom than those in *Y*?

For such reasons, measurement efforts have proceeded slowly, amid considerable discussion about the nature of economic liberty, the best proxies for its crucial elements, and the most suitable weighting techniques for such elements. From a conceptual standpoint, it is far from clear that more mechanical, quantitative approaches are superior to well-designed opinion polls; indeed, some eminent scholars have argued that rankings derived from more mechanical approaches must be tested against informed opinion to see whether they "make sense" and "work" (see, e.g., Friedman and Friedman 1992). The goal has always been to develop indicators of economic freedom that are accu-

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rate, useful, and relatively easy to tabulate. In the next section, we will summarize the major efforts to accomplish these tasks thus far.

The Major Measurement Efforts

A First Approximation

The list of those who can validly claim to have contributed to the rediscovery of the link between free economic institutions and economic growth is long—far too long for this survey. But it is probably fair to say that the first attempt to systematically measure economic freedom was produced by Raymond Gastil and Lindsay Wright for Freedom House in 1983, and grew out of Freedom House's annual report on political and civil liberties around the world (Gastil 1984).

Gastil and Wright assigned countries scores of 1 to 7 (1 signifying most-free) for political and civil liberties, and then supplemented this data with information on a country's economic system in order to assign each country a score for economic freedom (Gastil and Wright 1988). Milton Friedman correlated their rankings for civil liberties (which included consideration of private property rights, business freedom, and freedom from "gross government indifference or corruption") with two measures of economic welfare: he found that each one-unit improvement in a country's civil liberties score was correlated with a 34 percent reduction in infant mortality and a 49 percent increase in GNP per capita (Friedman 1988: 122).

This was clearly an exciting finding; predictably, efforts to measure economic freedom proceeded with a greater sense of urgency. For its part, Freedom House supported additional work aimed at refining the measures of Gastil and Wright. Simultaneously, other organizations began work on alternative measures that would focus more on economic (rather than political or civil) liberties. Symposia on the topic were sponsored by such organizations as the Mont Pèlerin Society, the Liberty Fund, the Fraser Institute, the Cato Institute, and the Heritage Foundation.

Scully's Studies

Gerald W. Scully was the first to build on the work of Gastil and Wright, enhancing their measures of economic liberty and subjecting them to rigorous empirical analysis. His work provided irrefutable evidence of the strong linkage between free economic institutions and various measures of economic and social welfare. In his first published report on the issue, Scully (1988: 661) concluded:

> The choice of the institutional framework has profound consequences on the efficiency and growth of economies. Politically open

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> societies, which bind themselves to the rule of law, to private property, and to the market allocation of resources, grow at three times (2.73 to 0.91 percent annually) the rate and are two and one-half times as efficient as societies in which these freedoms are circumscribed or proscribed.

More stunning findings would follow. In a later, book-length investigation of the topic, Scully (a) developed a more detailed theory of the relationship of a nation's constitutional setting and its economic performance, (b) produced more sophisticated measures of economic liberty, and (c) investigated the relationship of these measures to welfare. This work (Scully 1992) confirmed the favorable effects of economic liberty on income growth and efficiency, and also established that growth of the public sector has a depressing effect on economic growth. Finally, Scully (1992: 196–7) determined that liberty had favorable effects on the distribution of income as well as its level—a finding that was distinctly at odds with the common presumption that economic development and equity are incompatible:

> The evidence is that free societies have much larger shares of income going to the middle 60 percent of the [population] distribution than is observed in societies where men are not free to choose. . . .Equally revealing as a matter of equity is the status of the poor and the rich in free and statist nations. The income share of the highest income group is much larger in nations that repress individual rights than in those where rights are protected. . . .Economic progress and equity are not incompatible. Nations can move to a less restrictive rights regime and increase economic efficiency, economic growth, and equity.

Scully's work remains the most academically thorough investigation of the theoretical and statistical issues related to this topic. The empirical relationships he uncovered have been confirmed in subsequent studies (see, e.g., Barro and Lee 1994). And his work confirmed the urgency and importance of larger-scale efforts to gauge the extent of economic liberty across countries.

Three Freedom Surveys

Today there are three major surveys that measure economic liberty on a systematic (and, one hopes, continuing) basis: the Fraser Institute's economic freedom index, Freedom House's economic freedom indicators, and the Heritage Foundation's indices of economic freedom. While all focus on crucial elements of economic liberty such as the security of property rights and freedom of exchange, they also have different emphases and approaches.

1. *The Fraser Institute's Economic Freedom Index.* Participants at various symposia on economic freedom felt the Gastil-Wright

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approach might over-emphasize democratic political procedures and civil liberties in measuring economic freedom, and worked tirelessly over several years to develop alternative measures (see Walker 1988, Block 1991, and Easton and Walker 1992). The culmination of this effort was the publication in 1996 of *Economic Freedom of the World: 1975–1995*, which constructed three indices of economic liberty (using different weighting schemes for 17 components) for more than 100 nations over a period spanning two decades (Gwartney, Lawson, and Block 1996). Since economic institutions are ever-changing, and since enhanced economic freedom is likely to have favorable effects on welfare only with a time lag, this effort to evaluate freedom over a fairly broad time span was important. The study's authors concluded:

> Clearly, these data indicate that during the last two decades there has been a strong relationship between economic freedom and economic growth. Without exception, countries with either a *high level* or a *substantial increase* in economic freedom achieved positive growth. Correspondingly, the overwhelming majority of countries with *low* and/or *contracting* levels of economic freedom experienced declines in per capita GDP [Gwartney, Lawson, and Block 1996: 104].

2. *Freedom House's Economic Freedom Indicators.* Freedom House's efforts to supplement its annual reports on worldwide political and civil liberty eventually culminated in a free-standing publication, *World Survey of Economic Freedom: 1995–1996* (Messick 1996). Like Gastil and Wright's earlier efforts, the Freedom House index of economic freedom places significant emphasis on certain civil liberties (e.g., whether women or minorities are foreclosed from certain businesses or from owning or transferring property). Yet the *World Survey* confirms the importance of economic freedom as a determinant of prosperity:

> Whereas only 27 of those nations sampled, with just 17 percent of the world's population, merited a "free" rating, these 27 nations produced 81 percent of total world output. By contrast, the 20 nations rated "not free" contain more than a third of the world's people yet produce only 5 percent of total output. The *Survey* thus joins a handful of recent studies in showing that economic freedom is the surest path to growth and development [Messick 1996: 9].

3. *The Heritage Foundation's Indices of Economic Freedom.* Starting in 1994, the Heritage Foundation began to publish an annual *Index of Economic Freedom* (Johnson and Sheehy 1995, 1996). Heritage's aim differed slightly from that of other surveys: it sought to provide evidence on the utility (or lack thereof) of externally funded "development assistance" in facilitating growth. Heritage's *Index*

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added to the weight of evidence on the relationship of freedom to growth, and the study's authors added the following observations on U.S. foreign aid and growth:

> Of the 76 countries ranked as "mostly unfree" or "repressed" on the *Index*, 34 have received U.S. foreign aid for over 35 years, many for as long as 51 years. Of these 34 countries, 14 are poorer today than they were in 1965. Twelve more have essentially the same amount of wealth as they did some 30 years ago. Of the 34 long-term recipients of U.S. foreign aid ranked by the *Index* as lacking economic freedom, 26 are no better off than they were over three decades ago. . . .If development aid is essential to economic prosperity, why has there been so little progress by countries that are most dependent on foreign aid? The answer is simple: Economic freedom, not aid, is the key to economic development [Johnson and Sheehy 1996: 2].

Table 1 briefly summarizes the various indicators of economic liberty used in these surveys; Table 2 highlights the three surveys' rankings of "most-free" and "least-free" nations.

A scan of Table 1 makes clear that the three surveys of economic freedom share more similarities than differences. For example, all three surveys attach great importance to institutions which secure private property rights and enforce contracts. All three support freedom of international exchange of goods and capital. All three view barriers to entry into labor and product markets and controls on wages and prices with disfavor.

The chief differences have to do with the degree of emphasis on monetary stability and on the size of the government sector. Both the Fraser Institute and Heritage Foundation surveys take explicit account of the extent to which a country's monetary institutions have successfully controlled inflation; the Freedom House survey simply assesses whether there is an independent central bank that *might* protect against citizens' savings losses via inflation. In addition, both Fraser and Heritage include (as negative indicators) measures of the size of the government sector and tax rates; Freedom House is more neutral on these indicators. The latter difference explains why, for example, the Freedom House survey ranks such countries as Sweden, France, Norway, and Spain more highly than Fraser and Heritage (see Table 2).

Two Competitiveness Studies

Starting in 1989, the International Institute for Management Development (IMD) and the World Economic Forum, both based in Switzerland, jointly published an annual survey of the "competitiveness" of a reasonably large sample of nations' economies; in effect, the survey was an inventory of each country's competitive strengths and

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TABLE 1

INDICATORS OF ECONOMIC FREEEDOM USED IN THREE 1996 SURVEYS

Fraser Institute	Freedom House	Heritage Foundation
Protection of money as a store of value and medium of exchange Low money supply growth Low inflation rate Foreign currency accounts OK Bank accounts abroad OK	Freedom to hold property Private property rights Intellectual property secure Free exchange of property	Freedom of international exchange Low tariffs, trade barriers
Freedom to decide what is produced and consumed Low government consumption Few state-owned enterprises Absence of price controls No market entry restrictions Secure property rights, enforceable contracts, non-discriminatory courts No interest rate controls	Freedom to earn a living Free bargaining associations Absence of wage controls	Freedom to earn a living Low income, corporate taxes Low value-added, other taxes
Freedom to earn a living Low transfers/subsidies Low top marginal tax rate No military conscription	Freedom to operate a business Business formation easy No market entry restrictions Absence of price controls	Freedom to decide what is produced and consumed Low government consumption Few state-owned enterprises
	Freedom to invest earnings Market credit allocation Central bank independence No profit/interest controls	Protection of money as a store of value and medium of exchange Low inflation rate
	Freedom of international exchange Low tariffs, trade barriers Low travel barriers No exchange controls	Free flows of capital No foreign ownership limits or entry barriers No discrimination between foreign and domestic firms
		Open banking system No entry barriers for foreign banks Limited regulation of banking

(continued)

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TABLE 1 (continued)

INDICATORS OF ECONOMIC FREEEDOM USED IN THREE 1996 SURVEYS

Fraser Institute	Freedom House	Heritage Foundation
Freedom of international exchange Low tariffs No gap between official and black-market exchange rates Size of trade sector matches expectations No capital controls	Freedom to participate in the market economy Anti-discrimination rules Absence of corruption	Freedom to earn a living, operate a business Absence of wage controls Absence of price controls Freedom to hold property Private property rights Low probability of expropriation Limited business regulation No market entry restrictions Absence of corruption Limited black market

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TABLE 2

RANKINGS OF "MOST-" AND "LEAST-ECONOMICALLY FREE" COUNTRIES IN THREE 1996 SURVEYS

Fraser Institute	Freedom House	Heritage Foundation
	"Most-Free" Countries	
1. Hong Kong	1. Denmark	1. Hong Kong
2. New Zealand	1. Netherlands	2. Singapore
3. Singapore	1. New Zealand	3. Bahrain
4. United States	1. Sweden	4. New Zealand
5. Switzerland	1. United Kingdom	4. Switzerland
6. United Kingdom	1. United States	6. Netherlands
7. Canada	7. Austria	7. United States
8. Ireland	7. Belgium	8. Denmark
9. Australia	7. Canada	8. Luxembourg
10. Japan	7. Czech Republic	8. Taiwan
11. Netherlands	7. France	8. United Kingdom
12. Germany	7. Germany	12. Bahamas
12. Belgium	7. Ireland	12. Canada
12. Malaysia	7. Norway	12. Czech Republic
15. Thailand	7. Spain	15. Austria
		15. Japan
	"Least-Free" Countries	
88. Madagascar	67. Saudi Arabia	128. Sudan
88. Nigeria	67. Turkmenistan	129. Haiti
90. Cote d'Ivoire	67. Vietnam	129. Syria
90. Tanzania	70. Belarus	129. Zaire
90. Haiti	70. Iran	132. Myanmar
93. Zambia	70. Nigeria	133. Angola
93. Uganda	70. Uzbekistan	134. Azerbaijan
95. Romania	74. Syria	134. Iran
96. Burundi	74. Zaire	134. Libya
97. Brazil	76. China	134. Somalia
98. Nicaragua	76. Kazakhstan	134. Vietnam
99. Syria	78. Azerbaijan	139. Iraq
100. Algeria	78. Cuba	140. Cuba
101. Iran	80. Burma	140. Laos
101. Zaire	(Myanmar)	140. North Korea
103. Somalia	80. Iraq	
	80. North Korea	

NOTE: The Fraser Institute ranked 103 countries; the Freedom House ranked 82; and the Heritage Foundation ranked 142.

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weaknesses. The survey aimed to provide information both to corporate leaders (so that they could make better investment decisions) and to political decision-makers (so that they could improve economic policy).

In a widely read article, however, Paul Krugman (1994) pointed out that nations really do not "compete" in the way most people conceive of that term. In most competitions, there is a winner and a loser: economists refer to this as a "zero-sum game." Yet trade and development is a "positive-sum game." Trading partners are both winners, and one nation can enjoy higher standards of living without undermining living standards in other countries. Failure to appreciate this fact, Krugman would argue, risks the kind of economic conflict in which beggar-thy-neighbor policies evolve rather than wealth-enhancing ones.

Both the IMD and the World Economic Forum are attentive to these concerns; they seem to agree that the goal is to identify factors that are conducive to economic growth and development. Yet the two groups have been unable to agree on precisely how to refine the competitiveness index. As a result, they have recently produced competing competitiveness surveys.

1. *The International Institute for Management Development's World Competitiveness Yearbook 1996.* IMD defines competitiveness as "the ability of a country to create added value and thus increase national wealth by managing assets and process, attractiveness and aggressiveness, globality and proximity, and by integrating these relationships into an economic and social model" (Decosterd et al. 1996: 6). The IMD ranking of 46 countries is based on a combination of survey data and quantitative information about each nation's economy; remarkably, 224 variables affect the rankings.

2. *The World Economic Forum's Global Competitiveness Report 1996.* The World Economic Forum defines competitiveness as "the ability of a national economy to achieve sustained high rates of economic growth as measured by the annual change in gross domestic product per person" (Schwab et al. 1996: 8). The Forum ranking of 49 countries is, like IMD's, based on a combination of survey and quantitative data relating to 155 variables.

Table 3 summarizes the key characteristics of these surveys and lists the "most-" and "least-competitive" countries in each. As with the three surveys of economic freedom, the competitiveness surveys have much in common: an emphasis on openness to international trade, on well functioning capital markets, and on a lean and efficient government sector. Both surveys also place great weight on a country's stock of intellectual and physical capital—e.g., the abilities of manag-

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TABLE 3

CHARACTERISTICS OF TWO 1996 "COMPETITIVENESS" SURVEYS

IMD	World Economic Forum
Indicators of Competitiveness	
Domestic Economy Productivity Capital formation Past economic performance Competition governed by market forces	Openness Absence of barriers to foreign trade and investment
Internationalization Openness to trade Export-led growth Integration with international economy	Government Share of GDP spent by government Size of budget deficits Marginal tax rates
Government Minimal state intervention Predictable macroeconomic and social conditions	Finance Effect of financial markets on consumption and saving behavior
Finance Internationally integrated financial sector	Infrastructure Quality and quantity of physical assets
Infrastructure Well-developed business support systems, information technology, and efficient environmental protection	Technology R & D activities Support for higher education
Management Competitive price/quality ratio of products Long-run, efficiency orientation of management Entrepreneurial orientation	Management Attributes of management that may affect success of domestic companies in global competition
Science & Technology Investment in basic research Innovative application of existing technologies	Labor Labor costs relative to international norms Obstacles to hiring/firing workers Labor taxes Skill/education levels of labor force
People Skilled labor force Work ethic	Civil Institutions Protection of property rights Rule of law respected Impact of political and regulatory legislation

(continued)

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TABLE 3 (continued)

CHARACTERISTICS OF TWO 1996 "COMPETITIVENESS" SURVEYS

IMD	World Economic Forum
Ranking of Most Competitive Countries	
1. United States	1. Singapore
2. Singapore	2. Hong Kong
3. Hong Kong	3. New Zealand
4. Japan	4. United States
5. Denmark	5. Luxembourg
6. Norway	6. Switzerland
7. Netherlands	7. Norway
8. Luxembourg	8. Canada
9. Switzerland	9. Taiwan
10. Germany	10. Malaysia
Ranking of Least Competitive Countries	
37. Brazil	40. Colombia
38. India	41. Italy
39. Hungary	42. Turkey
40. Greece	43. South Africa
41. Indonesia	44. Poland
42. Mexico	45. India
43. Poland	46. Hungary
44. South Africa	47. Venezuela
45. Venezuela	48. Brazil
46. Russia	49. Russia

NOTE: The IMD ranked 46 countries; the World Economic Forum ranked 49.

ers, the skills of workers, and support for basic research. The World Economic Forum survey, however, gives the greatest weight to institutional factors such as protection of private property rights, the rule of law, and the economic impact of political and regulatory considerations.

Which Measure Is "Best?"

Differing Purposes

All five of these competing surveys of economic freedom and economic competitiveness are good; they are enormous intellectual under-

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takings which are carefully constructed and well executed. But each, to some extent, serves a different audience and purpose. We cannot reasonably discuss which is best without first asking: Best at what?

The IMD and World Economic Forum competitiveness surveys are essentially "growth forecasters" (where the relevant forecast horizon is the next five to ten years). They will be of primary value to business executives who are wondering, for example, where market growth is likely to be strongest or where productive facilities might be located most advantageously. They will be less helpful to scholars and policymakers who are considering what underdeveloped countries need (or need to do) in order to prosper.

Both IMD and the World Economic Forum base their surveys at least partly on quantitative data that is available only for developed economies. Thus, each ranks fewer than 50 countries—though these countries account for more than 90 percent of world output. But it is the countries they fail to rank in which the benefits of economic growth would be greatest and for which information about economic institutions would be most valuable.

More importantly, if the IMD and World Economic Forum surveys are used as guides for policymakers rather than as forecasting tools for managers, they might yield erroneous policy prescriptions. For example, in assessing the quality of a country's infrastructure, both surveys include a measure of the number of computers in use. Clearly, this is a variable that would be of great interest to a manager who contemplates marketing or producing a product in a particular country. But it would be wrong for a policymaker to reason that "competitiveness produces prosperity, and computers (at least in part) produce competitiveness; ergo we must invest heavily in computing capacity in order to generate prosperity in country *X*." Such logic (or illogic) is simply a variant of the "resources are all" fallacy that made early economic growth models such dangerous formulas for development assistance. No one would argue that computers cannot enhance productivity; the point is that they are neither necessary nor sufficient conditions for economic growth. Note, however, that we do not argue that the IMD and World Economic Forum surveys are "flawed" because they include this measure. Rather, we simply note that inclusion of this measure strongly suggests that the IMD and World Economic Forum surveys are intended for some uses and not others.

By contrast, the Fraser Institute, Freedom House, and Heritage Foundation surveys are all aimed at an audience of policymakers and scholars who are grappling with the following questions: What institutions are necessary preconditions for prosperity? And what policies can be put in place which will be most conducive to enhanced

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economic welfare for all citizens in both developed and developing nations?

In consequence, all three surveys of economic freedom focus on a smaller number of indicators and gather them for larger samples of countries than the two competitiveness surveys. Thus, all three have the advantage that they provide useful information about economic institutions in less-developed countries, where the benefits of growth would be greatest.

In addition, most of the indicators of economic freedom used in the Fraser Institute, Freedom House, and Heritage Foundation surveys concern matters that are directly related to government policy. Indeed, since these surveys make no attempt to gauge countries' endowments of infrastructure, managerial talent, or labor skills, it is hard to identify a single key indicator used which is not a direct outcome of the policymaking process—from tariff and tax rates to government spending to regulation of credit and product markets. Each indicator, then, reflects institutions which can be changed (though perhaps not easily or cheaply) by political means.

Finally, each of the three freedom surveys is based on variables thought to be necessary conditions for growth. Thus, these surveys reduce the risk that a policymaker or scholar might wrongly focus on resource inputs (e.g., "country *X* needs more computers! more roads! more R & D funding!") rather than institutions in devising a development strategy.

Statistical Correlations

Despite underlying differences in purpose, methodology, and philosophy, the various surveys produce rankings that have much in common. Table 4 shows Spearman rank correlation coefficients (denoted r_s) for the rankings in all five surveys. Each correlation coefficient in the table is calculated for the countries common to the relevant pair of surveys evaluated; a value of 1.00 would indicate that the paired surveys' rankings are identical.

As one might expect (given the common heritage of these surveys) the IMD and World Economic Forum surveys produced the most similar rankings (r_s = .88). The World Economic Forum, Heritage Foundation, and Fraser Institute surveys also have a great deal in common, with r_s ranging from .82 to .86 (in absolute value). Note that the negative correlations between the Heritage survey and other surveys is not an indication of widely divergent findings about the level of freedom across countries. Rather, the Heritage survey's freedom scores were devised so that lower scores indicated more freedom; in contrast, all other surveys were devised so that higher scores indi-

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TABLE 4

SPEARMAN RANK CORRELATION COEFFICIENTS FOR COUNTRY RANKINGS IN FIVE 1996 SURVEYS

	Fraser Institute	Freedom House	Heritage Foundation	IMD	World Economic Forum
Fraser Institute	—				
Freedom House	0.72** (n=62)	—			
Heritage Foundation	−0.85** (n=94)	−0.82** (n=75)	—		
IMD	0.82** (n=43)	0.62** (n=43)	−0.83** (n=45)	—	
World Economic Forum	0.86** (n=46)	0.49** (n=46)	−0.86** (n=46)	0.88** (n=46)	—

NOTES: n = number of countries common to both surveys; * indicates coefficient is statistically significant at the 95 percent confidence level; ** indicates coefficient is statistically significant at the 99 percent confidence level.

cated more freedom. As a result, the expected sign (+ or −) on all correlations between the Heritage survey's measure of freedom and any related variable will be the reverse of that expected for all the other surveys.

The Freedom House survey appears to have the least in common with the various other rankings; indeed, Freedom House is involved in every pairing for which the r_s falls below 0.80. To a large extent, this reflects Freedom House's historic emphasis on civil liberties and democratic institutions as crucial elements of economic freedom, and its relatively light emphasis on size of government in determining its rankings.

The high correlations among the surveys suggests that, when all is said and done, there is broad agreement about the institutions that are fundamental to economic freedom and growth. The fact that these correlations are not perfect (i.e., $r_s \neq 1.00$) suggests that there are differing views about what indicators matter most. But these differences provide us with a unique opportunity: If *all* the different survey measures turn out to have a statistically significant correlation with prosperity, then we will have additional evidence of the importance of economic institutions. Further, examination of each survey's explanatory power may tell us something about the most useful method of measuring freedom. It is to this task we now turn.

Liberty and Prosperity: What the Data Tell Us

The standard statistical technique for estimating the influence of one variable on another is ordinary least-squares (OLS) regression. Accordingly, we employ this method (following Friedman 1988) to estimate a simple model of liberty and prosperity, in which a country's GNP/capita (in log form) is a function of that country's level of economic freedom, its level of political/civil liberty (as measured by Freedom House surveys of this variable), and a constant term. That is, we use OLS regression techniques to estimate the coefficients a, b, and c in the following equation:

(1) ln(GNP/capita) = a + b(Economic Freedom) + c(Political/Civil Liberty).

In Table 5, we display the estimated coefficients, and related regression statistics, for five different versions of equation (1)—one for each major survey measure of economic freedom (or competitiveness)—for the countries common to all the surveys. In Table 6 we display the regression results for the larger samples of countries specific to each survey (and for which current GNP per capita and political/civil liberty data are available).

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TABLE 5

LIBERTY AND PROSPERITY: REGRESSION RESULTS FOR FIVE 1996 SURVEYS AND 29 COUNTRIES COMMON TO ALL FIVE SURVEYS (DEPENDENT VARIABLE: LN(GNP/CAPITA))

		Coefficient on Survey Measure of			
Survey	Constant Term	Economic Freedom	Political/Civil Liberty	Adjusted R-squared	F-statistic
Fraser Institute	6.6252** (13.34)	0.6160** (4.31)	0.2415** (4.91)	0.6519	27.16 (2, 29 d.f.)
Freedom House	7.9474** (9.07)	0.6768* (2.62)	0.1050 (1.18)	0.5385	16.92 (2, 29 d.f.)
Heritage Foundation	7.0245** (14.24)	−0.6931** (−4.86)	0.2003** (4.08)	0.6856	31.62 (2, 29 d.f.)
IMD	7.1751** (15.86)	0.7707** (5.89)	0.1848** (4.10)	0.7403	41.32 (2, 29 d.f.)
World Economic Forum	6.6174** (15.00)	0.7020** (5.53)	0.2423** (5.54)	0.7222	37.69 (2, 29 d.f.)

NOTES: *t*-ratios in parentheses below estimated coefficients; * indicates coefficient is statistically significant at the 95 percent confidence level; ** indicates coefficient is statistically significant at the 99 percent confidence level.

TABLE 6

LIBERTY AND PROSPERITY: REGRESSION RESULTS FOR FIVE 1996 SURVEYS AND EACH SURVEY'S FULL SAMPLE OF COUNTRIES (DEPENDENT VARIABLE: LN(GNP/CAPITA))

		Coefficient on Survey Measure of			
Survey	Constant Term	Economic Freedom	Political/Civil Liberty	Adjusted R-squared	F-statistic
Fraser Institute	2.7845** (3.10)	0.8847** (7.12)	0.3426** (5.37)	0.6960	101.9 (2, 89 d.f.)
Freedom House	2.3737* (2.11)	0.1746** (3.18)	0.2711* (2.45)	0.5631	44.47 (2, 69 d.f.)
Heritage Foundation	9.1615** (7.53)	−1.5295** (−8.56)	0.2108** (3.57)	0.6233	89.36 (2,108 d.f.)
IMD	2.8991** (4.00)	0.0281** (5.91)	0.3352** (6.08)	0.7476	57.76 (2, 39 d.f.)
World Economic Forum	3.0321** (4.10)	0.5946** (5.52)	0.4152** (7.95)	0.7546	64.58 (2, 42 d.f.)

NOTES: *t*-ratios in parentheses below estimated coefficients; * indicates coefficient is statistically significant at the 95 percent confidence level; ** indicates coefficient is statistically significant at the 99 percent confidence level.

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The results are quite remarkable. Table 5 shows that *every one of our five survey measures of economic freedom has significant power to explain variation in per capita national income.* The estimated equations explain from 54 to 74 percent of the cross-country variation in income; each coefficient on the survey measures of economic freedom carries the correct sign and is highly significant.

Note also that, in Table 5, the estimated coefficients on economic freedom range from 0.6160 to 0.7707 (in absolute value), while the estimated coefficients on political/civil liberty range from 0.1050 to 0.2423.[2] Thus, while both economic freedom and political/civil liberty contribute significantly to prosperity, *gains in economic freedom have a "prosperity dividend" that is three to six times greater than that which would be obtained from comparable gains in political/civil liberty.*

The regression results reported in Table 6 are even more impressive (as we might expect, given the fact that additional observations generally improve the precision of regression estimates). Each equation explains from 56 to 75 percent of the variation in income; every estimated coefficient on economic freedom has the expected sign and is statistically significant at the 99 percent confidence level.

Aside from providing strong evidence that liberty and prosperity are linked, the information in Tables 5 and 6 can be used to estimate the payoff from enhanced liberty. That is, we can use the aforementioned range of estimated coefficients on the economic freedom measures to calculate how much—holding all else constant—a given improvement in a country's economic freedom score is likely to raise that country's GNP per capita. Consider, for example, a representative country such as New Zealand, for which GNP per capita ($13,350) is at the median in the sample of countries included in the regressions shown in Table 5. Based on the range of estimates in Table 5, *a 10 percent increase in economic freedom in such a representative country can be expected to produce an increase in GNP per capita of 7.4 percent to 13.6 percent.*[3]

Clearly, the estimates in Table 5 suggest that enhancing liberty yields very large improvements in living standards. And recent history provides ample supporting evidence. New Zealand—our aforementioned "representative country"—is a particularly instructive example.

[2]Note that the various surveys' freedom scores have been "standardized" (i.e., transformed by subtracting the mean and dividing by the standard deviation) in order to make the coefficients reported in Tables 5 and 6 directly comparable to each other in numerical value.

[3]Given the log-linear specification of equation (1) above, the elasticity of GNP per capita with respect to economic freedom equals the estimated coefficient times the relevant value of the economic freedom measure.

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In the early to mid-1980s, New Zealand's economy was burdened by unstable monetary policy, high marginal tax rates, foreign exchange and capital market controls, and a large transfer sector. As a result, real GDP per capita fell for four of the five years from 1987–91. Since then, however, New Zealand has embarked on a program of monetary stabilization, market liberalization, and tax cutting. As a result, New Zealand's economic freedom score in the Fraser Institute survey improved by 33 percent from 1990 to 1993–95. The payoff has been phenomenal growth in real GDP per capita—exceeding 4 percent annually since 1992 (Gwartney, Lawson, and Block 1996: 178–9).

In sum, those who have been laboring in the "economic freedom vineyards" for these past years deserve praise; their efforts have been fruitful. They have proven that economic freedom is measurable; more importantly, careful examination of the data reveals that their measures are extraordinarily useful. It is true that differing points of view will produce (slightly) different freedom scores. But it is also true that these differences do not alter a finding which is of crucial importance: Economic freedom and economic wealth are inextricably linked. All signs point in the same direction: *those who would like people to enjoy greater prosperity must work to assure greater economic liberty.*

Liberty and Equality

The link between liberty and prosperity appears so strong, and the effects of prosperity on the quality (and length) of life appear so favorable, that it might be reasonable to ask: Why would anyone consider a development strategy that does anything other than enhance economic freedom? The answer has to do with concerns about the effects of economic growth on the distribution of income—on what, for better or worse, has come to be viewed as the level of "economic equality."

These concerns began in the 1950s, with some research by Simon Kuznets. Based on admittedly "scanty empirical evidence," Kuznets (1955: 18) opined that there would be "widening inequality in [the] early phases of economic growth" as economic development strategies took root. He was careful to qualify this view, noting that "[this] paper is perhaps 5 per cent empirical information and 95 per cent speculation," but concluded that "so long as it is recognized as a collection of hunches calling for further investigation rather than a set of fully tested conclusions, little harm and much good may result" (Kuznets 1955: 26).

The latter view would prove tragically wrong. Soon development officials accepted Kuznets' hunches as facts; they talked confidently

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about a "Kuznets U-curve of equality." As a country's income level grew, they presumed, there would be a painful period during which equality declined; only later would this disturbing trend toward inequality moderate and, eventually, reverse—perhaps as a result of redistributionist government policies. The implication was that development policy ought to emphasize income redistribution from the start, in order to protect the poor from the "excesses" and "harshness" of growth (see, e.g., Chenery et al. 1974).

There were two problems. First, as we have seen earlier, the tools of redistribution (a large government sector, high marginal tax rates, and attenuated property rights) can abort the development process before it gets under way. Second, there really is no firm theoretical or empirical basis for Kuznets' presumptions about growth and equality; *the Kuznets curve is a myth*. It is certainly *possible* that economic growth can be accompanied by periods of rising income inequality; there are even theoretical models to explain why this might occur. But there is no general theory which says this *must* occur. Indeed, neoclassical growth theory implies that the share of total income going to wage earners should remain constant, or even rise slightly, with development.

Of course, what matters most is not some theorist's speculations, but what actually happens. And the evidence is quite strong that growth does not produce more inequality at all—it produces greater equality.

The most careful cross-sectional work on this topic has been conducted by Scully (though, for an interesting study of one country over time, see Jackson 1994). Scully analyzed various measures of inequality and liberty for a sample of 70 countries, and concluded that "income is more equally distributed within countries that are politically open, that have private property and market allocation of resources, and that are committed to the rule of law than in countries where these rights are abridged" (Scully 1992: 184). More specifically, Scully found that freer societies have significantly higher shares of national income going to the middle classes (i.e., the 20th to 80th income percentiles), and less income received by the wealthy (the 80th to 100th income percentiles). Interestingly, there was no statistically significant effect of a country's institutional framework on the share of income received by the poorest in society: whether they lived in a free or tyrannical society, the poor's relative share of national income did not change much (though, of course, their absolute level of income was higher in freer, more prosperous countries).

Scully calculated that the favorable effects of liberty on equity are substantial. The share of national income going to the middle classes is 30 to 50 percent higher in most-free nations compared to least-

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free nations. And in the most-free nations, the share of income going to the richest fifth of the population is 25 percent lower than it is in the least-free nations. Overall, Scully observed, "income inequality is somewhat more than 50 percent higher in societies where individual rights are restricted. The lack of rights of individuals to compete for income streams has a large and bad effect on the income distribution" (Scully 1992: 193–4).

Scully's work, of course, pre-dated the five surveys of economic freedom that are the main subject of this report. We have found, however, that *the recent survey data basically confirm the link between liberty and equality*. In Table 7, we report the results of regressions which estimate a variant of equation (1), discussed earlier. Now the dependent variable is a measure of economic equality: the percent of national income that is received by the middle three quintiles of the population (i.e., the 20th through 80th income percentiles). As before, the explanatory variables are the various survey measures of economic freedom and the Freedom House measure of political/civil liberty. The results are not nearly so robust as those in Table 5 and 6; the equations explain from 12 percent to 30 percent of the variation in this measure of income equality. Nevertheless, all the coefficients on political/civil liberty are positive and significant at the 90 percent confidence level. And though only two of the five coefficients on economic liberty are statistically significant at the 90 percent confidence level, the weight of the collective evidence strongly suggests that economic freedom has a positive effect on this measure of economic equality.[4] In sum, while it is likely that political/civil liberty is a more potent contributor to economic equality than economic freedom, the latter has an important and salutary role to play as well.

We conclude: There is no reason to fear the process of development. Economic growth not only raises absolute standards of living but also improves the relative distribution of income as well. Prosperity is not the rival of equality but its partner.

Toward a "Pro-Freedom" Foreign Policy

For too long, policymakers have overlooked economic and political institutions that are crucial preconditions for economic growth. As a result, funds allocated to international development agencies and

[4]We employ the Stouffer method of constructing a hypothesis test combining several independent estimates (see Rosenthal and Rosnow 1984). Based on this method, the hypothesis of no relationship between economic freedom and this measure of equality can be rejected at the 95 percent confidence level.

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TABLE 7

LIBERTY AND EQUALITY: REGRESSION RESULTS FOR FIVE 1996 SURVEYS AND EACH SURVEY'S FULL SAMPLE OF COUNTRIES (DEPENDENT VARIABLE: PERCENT OF NATIONAL INCOME RECEIVED BY MIDDLE THREE QUINTILES OF THE POPULATION)

		Coefficient on Survey Measure of			
Survey	Constant Term	Economic Freedom	Political/Civil Liberty	Adjusted R-squared	F-statistic
Fraser Institute	28.775**	0.0672	1.3376**	0.1517	5.724 (2, 64 d.f.)
	(4.13)	(0.07)	(2.70)		
Freedom House	30.578**	−0.2234	1.4944*	0.1199	3.677 (2, 54 d.f.)
	(4.07)	(−0.57)	(1.97)		
Heritage Foundation	34.4762**	−0.5772	1.0667*	0.1217	5.197 (2, 75 d.f.)
	(3.80)	(−0.43)	(2.41)		
IMD	28.713**	0.1112*	1.0589	0.3020	6.921 (2, 32 d.f.)
	(3.73)	(2.30)	(1.81)		
World Economic Forum	32.2452**	2.0023	1.1840*	0.2484	5.783 (2, 35 d.f.)
	(4.22)	(1.90)	(2.19)		

NOTES: *t*-ratios in parentheses below estimated coefficients; * indicates coefficient is statistically significant at the 95 percent confidence level; ** indicates coefficient is statistically significant at the 99 percent confidence level.

programs have produced extremely low rates of return; in some tragic cases, the returns have actually been negative.

Consider, for example, U.S. foreign aid expenditures. Though some of America's $12 billion annual spending on foreign aid is for humanitarian aid and security assistance, about 62 percent is earmarked for various types of development and economic aid. Sixty-seven less-developed countries have been receiving such aid for 35 years or more (Johnson and Sheehy 1996: 7–8). Of these, 19 (28 percent) have shown negative growth in per-capita income since 1965. In every case, these increasingly impoverished countries show very low "freedom scores" on the various surveys of economic liberty discussed in this survey.

We would make two observations: (1) Absent the underlying institutions (secure property rights, freedom to transact, freedom from expropriation, etc.) that fuel productive investment and spur growth, no program of development assistance will meet its goals reliably and consistently. (2) It may be that aid actually *slows* the pace of reform by propping up those institutions (and their affiliated interest groups) most resistant to economic liberalization.[5]

There are hopeful signs that policymakers are rethinking development strategy, however. In 1993, Vice President Gore's "Reinventing Government" initiative recognized the need for reform of the U.S. Agency for International Development (AID). Partly in response, the Foreign Aid Reduction Act of 1995 included language that would have conditioned aid disbursements on attainment of some threshold level of economic freedom (based on the findings of a study similar to the various surveys reviewed earlier). Though approved by the Senate Foreign Relations Committee in 1995, the bill never came to a vote in the full Senate. Although it is clear that foreign aid is not a necessary condition for economic growth, the proposed bill at least recognized that aid can be useless or positively harmful.

The slow pace of change results from standard interest-group politics. Simply put, there is a constituency for the status quo. Many of the development-aid dollars expended each year flow to U.S. firms supplying equipment and services to recipient countries. By one estimate, out of every dollar we designate to help the poor overseas, 70 to 80 cents stays in the United States (Johnson and Schaefer 1997: 14). The firms and individuals who benefit from this spending, quite

[5]In the language of a 12-step recovery program, aid is a form of "enabling behavior" that keeps a society from recognizing the kinds of institutional changes that need to be made, thus postponing the adoption of reforms that can lead to growth and development.

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naturally, have a very strong interest in resisting changes in the nature of aid.

Changing this political calculus will not be easy. But we can take some encouragement from the recent debate about domestic welfare policy. In the early 1980s, when scholars such as Charles Murray (1984) began documenting the pernicious effects of U.S. social policy over 1950–80, reform was regarded as an impossible dream—and those who argued for change were lonely voices. Yet, within a decade, reform was underway, and it was the defenders of the status quo who were the lonely voices. Patiently and persistently, the reformers had produced a new intellectual (and, ultimately, political) consensus that had made change inevitable.

We are now well on our way to a similar consensus regarding economic liberty and foreign aid. Relatively few scholars doubt that economic freedom is a necessary condition for prosperity; the myth that economic growth endangers economic equality also is giving way to hard evidence to the contrary. More than ever before, policymakers appear ready to enshrine economic freedom alongside political and civil liberties as crucial elements of a decent and just society. Once we make enhanced economic liberty a central goal of foreign policy, the benefits of prosperity and equality will be enjoyed more widely than at any time in history.

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How State Regulation of the Internet Violates the Commerce Clause

Dan L. Burk

Usage of the global Internet computer network is rising exponentially (Waldrop 1994: 880). Not surprisingly, attempts at governmental regulation are not far behind. Although Congress has paid some attention to the Internet in the form of the recently invalidated Communications Decency Act, state regulators seem equally anxious to leave their mark on the burgeoning field of cyberlaw. The Georgia legislature has attempted to prohibit Internet users from "falsely identifying" themselves online.[1] Similar legislation is pending in California.[2] The Minnesota Attorney General, Hubert Humphrey III, seeing no need to enact any new laws regarding the Internet, has hastened to deter what he considers to be online violations of Minnesota law, filing a flurry of lawsuits against out-of-state advertisers and service providers (Eckenwiler 1996: S35). The Illinois Attorney General's office is by all accounts equally eager to get into the cyberspace regulation game.

The potential negative effects of such state regulation on the growth and productivity of the Internet are at the very least alarming. The Internet extends beyond the boundaries of any of the states, and the effects of state regulation will likewise spill over state borders. Such regulatory leakage implicates constitutional doctrines designed to preserve both the sovereignty of the individual states and the coherence of the United States as a whole. Thus, the prospect of states applying haphazard and uncoordinated multijurisdictional regulation to the Internet's seamless electronic web raises profound questions regarding the relationship between the several states. To date, legal challengers to state regulation have primarily posed those questions as issues of personal jurisdiction, that is, as challenges to the states' ability to hale

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[1]Ga. Code Ann. § 16-9-9.1 (1996).

[2]California Senate Bill SB-1533 (1996).

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out of state defendants into their courts. However, the recent decision of the federal district court in *ACLU v. Pataki* promises to fuel a new wave of legal challenges to state regulation couched as issues of unconstitutional regulation of interstate commerce.

The Nature of the Net

In *ACLU v. Pataki*, a coalition of public interest organizations successfully challenged New York state's "little CDA" law, which prohibited making sexually explicit materials available online to minors. The court held this to be an unconstitutional burden upon interstate commerce. This holding rests directly upon the unique nature of the Internet. The technological miracle that has provoked these issues is perhaps been best described as a network of networks: local computer systems hooked to regional systems hooked to national or international high-capacity "backbone" systems (Cerf 1991: 72). Each link, or node, in this web is a computer or computer site, all connected to others by a variety of means: fiber optic cable, twisted-pair copper wire, microwave transmission, or other communications media. Each computer in the network communicates with the others by employing machine-language conventions known as TCP/IP, or the Internet Protocols (Schultz 1988: 72). Indeed, it is these protocols that define the network; those machines that talk to one another using IP are the Internet.

The medium defined by these shared protocols is distinctly unlike any other (Krol and Ferguson 1995: 26). There is no centralized control of data routing, or for that matter, of almost any other aspect of the Internet (Negroponte 1991: 106). From a technical standpoint, each computer acts autonomously, coordinating data traffic with its nearest connected neighbors, and guided only by the "invisible hand" that arises from the sum of millions of such independent actions. From a management standpoint, each node is similarly autonomous, answering only to its own systems administrator. This means that there is no central authority to govern Internet usage, no one to ask for permission to join the network, and no one to complain to when things go wrong.

Additionally, the Internet protocol provides for "telepresence," or geographically extended sharing of scattered resources. An Internet user may employ her Internet link to access computers, retrieve information, or control various types of apparatus from around the world. These electronic connections are entirely transparent to the user. The "virtual machine" created by the connection appears to be the one at the user's fingertips—indeed, depending upon local network

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traffic, a distant facility may prove to be faster and more responsive than one in the next room. Internet users may therefore be completely unaware where an online resource is physically located. Moreover, it is frequently impossible to determine the physical location of a resource or user. Such information is unimportant to the network's function or to the purposes of its creators, and the network's design thus makes little provision for geographic discernment.

This unique medium makes available a vast array of interconnected information, including business information. Increasingly, electronic commerce is becoming an important component of interaction online. Businesses of all types routinely use the Internet for a variety of commercial transactions, and consumer services have begun to appear. At present, commercial traffic on the network generally culminates in an exchange of physical goods, and it is presently possible to access a variety of mail-order catalogs on-line, to arrange for purchase of music, books, fast food delivery, even flowers. The variety and availability of such consumer services is likely to grow, as are attendant facilities for online advertising and marketing.

However, the network also offers novel opportunities for transactions involving information-based goods and services. The Internet already supports access to a wide variety of information utilities including databases and computational facilities, as well as archives of text, music, graphics, and software. Information and information-based services on the network have traditionally been offered for free, but will increasingly be offered on a commercial basis. Unlike transactions involving physical goods, delivery of digitized information products such as music, photographs, novels, motion pictures, multimedia works, and software can be accomplished entirely within the network itself. Such information products already constitute a sizeable portion of the gross national product of developed nations. That portion is likely to increase worldwide, and the Internet will facilitate such increases. As online commerce continues to grow, attempts at governmental regulation are sure to follow.

Competitive Federalism

In the United States, regulatory power is divided "vertically" between the states and the federal government, and "horizontally" among the several states. The latter division of power is of primary concern for the Internet. At first consideration, the value of horizontal federalism may seem elusive: myriad states, each with a different legal structure, would seem to foster chaos in determining interstate legal obligations. At minimum, the reality of operating under a variety of

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legal regimes introduces complexity and additional costs into both individual and business planning.

However, the benefit of jurisdictional diversity has long been celebrated at least anecdotally in the legal literature: diversity forestalls legal and political stagnation. Within the so-called laboratories of the states,[3] various legal regimes may be composed and field tested in an attempt to evolve optimally efficient regulatory systems. Deficiencies or virtues in the respective state systems are expected to become manifest, leading to a "weeding-out" of undesirable rules and promotion of superior approaches. The implication of the "laboratory" metaphor has been that regulatory schemes that prove successful on a small scale may be adopted on a larger scale, either by other states or by the federal government.

More formal public choice models have built upon this intuitive recognition of the benefits of federalism (Epstein 1992: 147). Public choice theory predicts that representative government will frequently be subject to capture by special interest groups (Olson 1965, Buchanan and Tullock 1962). This arises in part from the low marginal value of voting as compared to the higher marginal value of activities such as lobbying. Voters may tend to be "rationally ignorant" or "rationally indifferent" — because a given vote is so unlikely to affect the outcome of an election that it is frequently not worth individual voters' time and effort to bother learning enough about the issues to cast an informed vote, or even to engage in voting itself. By contrast, special interest groups may see substantial pay-offs from activities that may be characterized as "rent-seeking," that is, expending time and money in order to use governmental mechanisms to secure competitive advantages (Tullock 1967: 232).

As a consequence, jurisdictions may become encrusted with special-interest legislation that not only fails to reflect the interests of the majority of voters, but also burdens a wide variety of business and personal activity (Posner 1992: 638). However, one of the virtues of a federal system is that individuals and businesses may express their preferences in more than one manner: when voting at the ballot box fails, they may opt to "vote with their feet" (Epstein 1987: 1454). Local governments that are captured by special interests, or that otherwise fail to reflect voter preferences, may find themselves losing constituents to more responsive regimes. Conversely, jurisdictions that are responsive to constituent preferences may tend to attract new constituents.

[3]New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (describing the states as the laboratories of democracy).

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The production of local public goods and services might thus resemble the production of private goods in a competitive market: competitive pressure from other jurisdictions will prevent any given jurisdiction from offering too much or too little in the way of public services. Jurisdictions that offer too much will experience an influx of immigrants from less generous jurisdictions; jurisdictions that offer too little will experience an exodus to more generous jurisdictions. Migration in or out of the jurisdiction will continue until parity with competing jurisdictions is reached. These forces will tend to act as a check on overproduction or underproduction of local public goods. By "voting with their feet," or exiting, citizens force local politicians toward efficiency in allocation of resources to such goods (See Hirschman 1970). Indeed, just as in classic cartel theory the threat of entry deters monopoly profits, so in public choice theory the threat of "exit" may deter special interest regulation from accumulating (Breton 1991: 40).

Thus, if citizens are free to migrate between jurisdictions, competition for desirable citizen immigrants will arise (Tiebout 1954: 416). Local communities will offer to potential immigrants the most attractive packages of goods and services at the lowest tax rate possible. Similarly, migrants will relocate to jurisdictions offering the maximum package of public goods at the tax rate that the migrant is willing to pay. Local communities may even tailor their offerings to appeal to particular types of immigrants, and immigrants would be expected to sort themselves out into groups of similar means and tastes by jurisdiction.

Businesses, too, may "vote with their feet," locating their operations in jurisdictions that offer the most attractive set of local public goods. This in turn implies that jurisdictions may tailor their offerings to attract businesses, or to attract certain kinds of desirable businesses, or even to repel undesirable businesses. One example of such competition may be seen in the "Delaware phenomenon," the empirical observation that a large number of corporations choose to incorporate under the laws of Delaware (Bebchuck 1992: 1435). Much of this effect is now believed to result from interstate competition in "law as a product" (Romano 1985: 225). Delaware appears to have attracted the lion's share of incorporations because the Delaware legal system has specialized in corporate law, offering additional certainty to firms seeking incorporation. Delaware offers not merely a highly developed statutory system, but also a court system with a high degree of expertise in resolving corporate conflicts, and a considerable body of case precedent governing such conflicts. Thus, the total package of Delaware's law succeeds in the incorporation marketplace as a superior product.

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Similar interstate competition in the market for other "law products" are predicted by the competitive federal model.

Competition and Cooperation

However, the competitive law model assumes that jurisdictions are tightly compartmentalized so that no external costs or benefits accrue from the local provision of public services. If jurisdictions are "leaky," then individuals could perhaps enjoy the positive benefits of a neighboring jurisdiction's policy without actually incurring the cost of migrating there (Stiglitz 1983: 19). More significantly, in a world of "leaky" borders, jurisdictions could lower the costs of regulation to local firms by imposing all or part of those costs on neighboring jurisdictions. This type of activity might serve to attract firms to a particular jurisdiction, but not necessarily by generating a net gain in efficiency (Posner 1992: 638).

The states may attempt to avoid such a race by entering a cooperative agreement that forbids such a "race to externalize" (Trachtman 1993: 73). However, as in the case of classic economic cartels, such a governmental cartel is likely to be highly unstable (Stigler 1977: 44). If cooperative strategies prove impossible or unworkable, rational competitors may have yet another option. If "horizontal" cooperation between jurisdictions proves unstable, the creation of a "third party" standing in a vertical relationship to the competitors may be necessary (Breton 1991: 48–49). Especially where externalities exist, centralized decisionmaking, rather than interjurisdictional competition, may be required to achieve an efficient outcome. Stated in game theoretic terms, knowing that their own rational short-term competitive preferences will inevitably lead to their own detriment in the long term, states may choose to voluntarily surrender all or part of their decisionmaking power to a third party.

This is in essence the strategy adopted by the individual states of the United States in acquiescing to their constitutional compact that creates a centralized federal government. As the colonial parties to the Articles of Confederation quickly found, certain activities are poor subjects for a cooperative agreement, because it is too attractive to "defect" from the agreement. The solution was to shift regulation of such activities to a central government under the federal constitution (Epstein 1987: 1455). However, under the federal constitution, even when some types of interstate regulation have been centralized, the benefits of interstate competition have also been preserved to the extent deemed practical. Because competitive benefits will be lost in whichever markets are centralized, centralization must be considered

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a drastic measure taken only where no such efficiencies are to be had; that is, where externalities prevent the development of competition in the first instance.

However, in order for competitive benefits to be maintained, jurisdictional compartmentalization is essential. Thus, the federal compact not only "vertically" transfers certain powers to the federal government, it also defines the "horizontal" relationships between the states that are party to the compact. Significant portions of the constitution appear designed to preserve the jurisdictional conditions necessary for competition in "law as a product." In particular, the Commerce Clause in its dormant aspect forms a constitutional barrier against jurisdictional overreaching by the states. The unprecedented interconnectivity created by the Internet poses new challenges to the jurisdictional aspects of this provision; if the Commerce Clause is to continue serving its proper function in an online environment, its role as a buffer for competitive federalism must be kept firmly in mind.

Instruments of Commerce

This suggests that constitutional parameters for the proper limits of state Internet regulation may be found in dormant commerce analysis (Eckenwiler 1996: S35), and this was the theory adopted by the court in the *Pataki* case. The Commerce Clause of the United States constitution grants to Congress the power to regulate interstate commerce. In its negative or "dormant" aspect, the commerce clause limits the ability of states to impede the flow of interstate commerce (Tribe 1988: § 6-3). Most especially, the dormant commerce clause enjoins the states from the practice that prompted the clause's adoption, a practice endemic under the Articles of Confederation: economic protectionism.

Under the dormant commerce clause, states are not totally barred from regulation of commerce, but a state may not discriminate against articles of commerce from outside the state solely on the basis of the articles' geographic origin. Neither may a state sacrifice the unity of the national market in order to reap purely local benefits. Tariffs and taxes against out of state commerce are almost per se prohibited, but more subtle non-tariff barriers may be prohibited as well. States may have legitimate non-protectionist regulation interests, such as protecting local health and safety, that will burden interstate commerce. If the statute treats domestic and out-of-state commerce equally in order to achieve some legitimate local purpose, incidental effects on interstate commerce will be tolerated unless those effects exceed the putative local benefits.

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These rules constitute in part an adjunct to the federal system for situations in which the right of exit alone may not preserve the benefits of interjurisdictional competition (Epstein 1992: 160). For example, the dormant commerce requirements modulate the multistate coordination problem inherent in building interstate facilities such as a railroad, or in operating interstate business ventures such as those of a major insurer. If each state can impose restrictions on the portions of the venture within its territory, then each state can act as a "hold-out," seeking to extract from the interstate enterprise the profits from the entire venture (see Cohen 1991: 351). Alternatively, the aggregate cost of inconsistent state demands may well exceed the total value of the interstate enterprise. However, the dormant commerce clause forestalls such dissipating regulation by its nearly per se rule prohibiting open discrimination against out-of-state commerce, and by prohibiting even facially nondiscriminatory regulation that is overly burdensome to interstate commerce.

The similarity of the Internet to previous interstate "instruments of commerce" such as railroads or trucks is striking. Given that the Internet is not simply a means of communication, but a conduit for transporting digitized information goods such as software, data, music, graphics, and videos, there may be a variety of instances where state regulation of network traffic constitutes an impermissible burden on commerce similar to burdensome regulation of tractor-trailer mud-flaps, or of the length of railway trains. For example, several states have considered enacting provisions designed to prohibit access to on-line pornography; some such provisions would make the Internet service provider (ISP) liable if such images were transmitted on her system. However, as discussed at some length above, it is unrealistic to believe that the ISP can screen or block such images. ISPs facing this type unavoidable liability may simply choose to shut down, a result that suggests that such measures are ripe for challenge as an impermissible burden on interstate commerce. Thus, there is a likelihood that state regulation of the Internet will raise the same kind of "hold-out" or coordination problems previously addressed by the dormant commerce clause cases.

However, in the case of the Internet, such state regulatory peccadillos will strike far closer to core liberties than those previously experienced. People familiar with the Internet know that one of the network's great benefits is that the average citizen can participate for a relatively small investment. In the past, communicating or catering to a national constituency required heavy capital outlays; the Internet makes nationwide communication and commerce accessible to citizens for as little as a few hundred dollars (Krol & Ferguson 1995: 23).

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But the prospect of multijurisdictional liability may raise the price of participation beyond the average citizen's reach. Much of the network's democratizing influence may be lost if the threat of unseen, lurking multijurisdictional liability deters all but the most heavily capitalized entrepreneurs from pursuing all but the most highly profitable ventures. The average user simply cannot afford the cost of defending multiple suits in multiple jurisdictions, or of complying with the regulatory requirements of every jurisdiction she might electronically touch. Thus, the need for dormant commerce nullification of state overreaching is greater on the Internet than any previous scenario.

Exporting Law

The language of the "instruments of commerce" cases relies implicitly on the "vertical" federal relationship created when the states ceded to the central government authority to regulate interstate commerce in order to avoid certain external costs of interjurisdictional competition. A complementary line of Supreme Court cases recognizes a role for the dormant commerce clause in modulating "horizontal" federal relationships. Whereas the "instrument of commerce" case prohibit states from impeding the ability of businesses to "vote with their feet," these complementary cases hold that the dormant commerce clause operates to prohibit states from exporting their law "products" into the local markets of sister states.

For example, in *Edgar v. MITE Corp.*,[4] the Supreme Court analyzed the ability of a state to dictate corporate merger guidelines to wholly out-of-state corporations. The Court looked at this question through a dormant commerce lens, holding that a statute allowing one state to interdict a tender offer to not only its own residents, but to shareholders in other states, offended the dormant Commerce Clause. The opinion suggested that this was not simply because the state had intruded on power reserved to Congress, but because of the intrusion upon the sovereignty of sister states.

Similarly, in *Healy v. The Beer Institute*,[5] the Court struck down a Connecticut statute that required beer merchants to certify that they offered their products for the same price in states neighboring Connecticut as they did in Connecticut itself. The effect of the statute was to impermissibly regulate beer pricing outside the borders of the state; the Court held that state regulation of activity wholly outside

[4]457 U.S. 624 (1982).
[5]491 U.S. 324 (1989).

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the borders of a state offends the commerce clause, whether or not the activity has some effect within the state. The court emphasized that "the Commerce Clause dictates that no State may force an out-of-state merchant to seek regulatory approval in one State before undertaking a transaction in another."

Most recently, in *BMW of North America v. Gore*,[6] the Supreme Court overturned a punitive damage award assessed against an automobile manufacturer that failed to disclose re-painting of new cars damaged in transit from factory. This nationwide practice by the manufacturer violated the consumer fraud provisions of the state of Alabama, where the punitive damages were awarded. However, the defendant showed that its practice complied with the requirements of at least 25 states. The Supreme Court opinion emphasized the impact that punitive damages awards in one state might have on the substantive policies of sister states. The Court stressed that a state cannot impose economic sanctions on violators of its laws in order to induce those entities to alter their lawful conduct in other states.

Regulation and Competition

The function of this constitutional principle seems clear as a matter of competitive federalism: states may not attempt to externalize the costs of their domestic regulatory schemes on other states, or "export" their domestic regulations into another jurisdiction (Posner 1992: 638–9). The most blatant attempt to do this appears in *Healy*, where Connecticut's certification program was admittedly designed to deter Connecticut residents from driving to neighboring states to purchase beer at lower prices than those available in Connecticut—in other words, Connecticut hoped to deter its residents from "voting with their feet" against the state's regulatory scheme. Only by inducing beer distributors to artificially inflate their prices in neighboring states could Connecticut hope to deter such exit. But by forcing a price increase in neighboring states, Connecticut would effectively export the costs of its domestic regulation to its neighbors, potentially frustrating their own domestic regulatory schemes. *Edgar* and *BMW* arose from similar attempts to export the costs of domestic regulation of, respectively, securities or products disclosures. The dormant commerce doctrine articulated in these cases functions as a buffer against such externalization of regulatory costs.

This principle has important ramifications for on-line commerce. Take, for example, the activities of the Securities Bureau in the state

[6]116 S.Ct. 1589 (1996).

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of New Jersey. These state regulators have taken a highly pro-active stance toward supervising on-line investment solicitations, and with good reason: a variety of fraudulent investment schemes have appeared both on the Internet and on proprietary systems such as America OnLine (McGeehan 1996: 1A). However, at least some of these regulators have adopted the rather extreme position that any electronic communication which may be received in New Jersey, and which meets the local statutory definition of a "security" is subject to New Jersey securities law, including local requirements of registration and disclosure (Silverman 1995: 10). A former chief of the Bureau has opined that on-line offerings by registered brokers in other jurisdictions, even when legitimate and accompanied by full disclosure, violate New Jersey law if the broker is not registered in New Jersey (Sherman 1995: A3). This position looks suspiciously similar to that of Illinois in *Edgar v. MITE*: a state demanding that out-of-state businesses comply with its domestic securities law, even if the business has fully complied with the securities law of its own state. Indeed, under the New Jersey rationale, online activity is subject to New Jersey regulation whether or not it has any effect in the state. To trigger regulation, the offer need only be electronically accessible from New Jersey, whether or not anyone from New Jersey actually invests. In effect, under this policy, New Jersey is attempting to dictate to the entire nation—if not the world—what the standards for investment offerings shall be.

As a practical matter, this position is untenable. Because of the geographic indeterminacy of the Internet, online businesses and content providers simply cannot tell with any degree of assurance the geographic location from which access to data has been requested, and there is no practical way to screen out contacts from particular jurisdictions. The end result is that on-line businesses have no way of knowing whether their communications, advertisements, transactions, and even shipments of digital goods comply with the regulatory regime of wherever the goods or information may end up, because there is no reliable way to ascertain where the data *will* end up. If online businesses are subjected to the regulation of every potential jurisdiction, Internet commerce will face an almost insurmountable burden in attempting to predict what requirements might be imposed upon it.

This is not to argue that ignorance of the law is an excuse. Given the finite number of U.S. jurisdictions that might have contact with an Internet site, there are only a finite number of applicable state regulations. Businesses could gather information on all the potential regulations—this would be burdensome, but not impossible. The question would then be what strategy a business should adopt, knowing

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the possible rules, but being uncertain which might apply. Two strategies might be expected to emerge, depending on the pattern of regulation. In instances where the regulation of the 50 states was consistent but merely differed in magnitude, the "lowest common denominator" would have to prevail—if, for example, various states required increasing levels of disclosure about a product or transaction, an online business could opt to offer the highest level of disclosure required. By complying, as the case might be, with either the most demanding or restrictive regulatory regime, a business might satisfy the lesser included requirements of all the other jurisdictions as well.

A different result would be expected where state regulations were inconsistent—if, for example, some jurisdictions required disclosure of certain facts about a product or service, but other jurisdictions forbade such disclosure. In such instances, being unable to predict which jurisdictions' regulation might apply, and being unable to comply with all the potential requirements, on-line businesses might choose to comply with the rule of the majority of jurisdictions, and hope that no transactions occurred where compliance was lacking. But unless the possibility of such transactions were very small, or the penalties for non-compliance were substantially outweighed by the profit to be had from taking the risk, it seems more likely that rational businesses would simply cease to transact business online (Epstein 1992: 160).

The Interstate Laboratory Online

Under the traditional commerce analysis, either of these results is likely to place a serious burden on interstate commerce; depending on the local benefits to be gained by the regulations, the burden may or may not be undue. At least in the situation where online businesses are conflicted out of the market, the detriment to commerce would appear so severe that it is difficult to imagine what local benefits would be sufficient to compensate. This may not always be true in the "lowest common denominator" situation. In the example given of product disclosure, excessive disclosure dictated by the most demanding jurisdiction may be costly, but one can imagine that consumers might benefit enough to outweigh the costs.

However, from the perspective of competitive federalism, the situation is far more grave than the traditional balancing test might suggest. If the "lowest common denominator" prevails among on-line services, then the "laboratory of the states" is disabled. No state wishing to experiment with a lesser level of regulation will be able to do so. Similarly it goes almost without saying that the "laboratory" is disabled

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in the situation where on-line services are driven out of business by conflicting requirements. Either result arises out of the inability in an on-line environment to geographically circumscribe contacts. In essence, if businesses are subjected to a state's regulation merely on the basis of online contacts, then the businesses cannot "exit" or "vote with their feet" to escape the burdensome regulation of a particular jurisdiction—the regulation follows them wherever they go.

This constitutes an enormous problem for horizontal federalism. A particular state cannot be permitted to dictate to the entire country the regulatory standards for any activity. It is one thing if a particular state wishes to regulate all the businesses within its borders out of existence—the result simply constitutes a terrible failure (or, depending on the state's goal, perhaps a spectacular success) of that state's regulatory experiment within its own laboratory. Excessive in-state regulation may be checked either by disgruntled voters or by a mass exodus of affected firms. But it is another matter entirely if it regulates out of existence businesses that its sister states are attempting to foster within their borders. Sister state constituencies have no opportunity to be heard at the ballot box, and firms cannot "vote with their feet" if there is nowhere beyond the reach of the objectionable regulation to flee.

If national uniformity is to be imposed on a regulatory matter then it is the prerogative of the federal government to do so, and not the prerogative of a particular state. In some instances the Internet will facilitate externalization of domestic regulatory costs—perhaps a state could decide to attract businesses by permitting very lax Internet advertising standards bordering on deception. One would expect that costs of any deception that would result from the lax regulation would accrue primarily outside the permissive jurisdiction, effectively forcing out-of-state residents to pay for the permissive state's system. Yet such a situation does not justify extraterritorial application of other states' more stringent regulations to reach the shady advertisers. To the extent that some Internet activity may facilitate externalization of regulatory costs, then the competitive federal model will function poorly in those areas. But this means that federal regulation, not extraterritorial state regulation, is required—precisely the reason that, under the federal constitution, regulation of commerce was placed in the hands of a central authority. At least at the federal level, the competitive interests of other states have the opportunity for representation, which will not be the case at the "horizontal" level of a sister state's regulatory scheme.

Conclusion

State regulators may of course complain that the constitutional constraints I have outlined, and which have now been adopted by at

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least one federal court, will prevent them from protecting their citizenry against the very real threats of fraud and vice on the Internet. The answer to such an objection is that although the state may not regulate the citizenry of other states, it is perfectly free to regulate its own citizenry: Minnesota is welcome to penalize Minnesotans who engage in on-line gambling, and New Jersey is welcome to require its residents to file disclosures certifying that they have thoroughly investigated any on-line opportunity in which they decide to invest.

Demand-side regulation is naturally less convenient for the state regulators, but the federal system considered here was not designed with the convenience of regulators in mind. It is rather designed to maximize individual liberties by forcing local governments into a competitive market for regulation. If citizens value stringent protection from on-line fraud and vice, and one state or another offers such protection, then that state may expect an influx of citizens seeking the safety of that regime. If, on the other hand, citizens find such regulation overly burdensome, then that judgment will similarly be manifested either by voice or exit, and the regime should go the way of previous failed experiments from the laboratory of the states.

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The Rationing of Transplantable Organs: A Troubled Lineup

Charles T. Carlstrom and Christy D. Rollow

On June 6, 1995, baseball legend Mickey Mantle was placed on the transplant waiting list after being diagnosed with end-stage liver disease caused by hepatitis, liver cancer, and years of alcohol abuse. Two days later, he underwent surgery, despite the fact that the average liver transplant patient waits 67 days. His doctors claimed that Mantle received no preferential treatment; rather, his gravely ill status placed him at the top of the list. Yet, because of Mantle's original liver cancer, he died two months later. Given that 804 patients died in 1995 while awaiting a liver transplant, Mantle's case and others like his raise questions about which of the 7,400 liver patients on the waiting list should have received the 3,900 livers that became available that year. Society has to confront this and similar questions because of the severe shortage of transplantable organs.

Organs are not the only goods rationed in the United States—they are just the most controversial. Hunting permits, oil drilling leases, cellular telephone licenses, and radio frequencies are other examples of rationed resources. The distinguishing feature of these goods is that prices alone are not permitted to allocate the commodity; as a result, someone must determine how they will be distributed.

There are many ways that goods can be rationed, such as lotteries, first-come, first-served, and coupons. As a consequence of price controls, gasoline was rationed in the 1970s, largely on a first-come, first-served basis.[1] The result was long lines at the pumps and an effective

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[1]Some states developed other rationing schemes based on license plate numbers and birthdays. These were largely ineffective in reducing queuing.

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price of gasoline that included both the direct cost of purchasing gas plus the indirect cost of queuing. Although some view such a system as equitable, its inefficiencies are obvious once we factor in the time and even the gas wasted as people waited in line. Rationing also played a role during World War II, when the government issued coupons for purchasing staples such as meat and butter. This solution was also seen as equitable in many quarters, although, like lotteries, it did not ensure that those who most needed or valued a good received it.

This conflict between equity and efficiency arises whenever goods are rationed. Determining the most equitable way to allocate gasoline and food is difficult, but deciding how to allocate transplantable organs is infinitely more complex. The complexity stems from the fact that someone must choose who receives lifesaving transplants—a decision that impacts efficiency through the number of lives lost over time. Since both equity and efficiency are paramount when rationing goods, the market for transplantable organs is an ideal case to illustrate this conflict.

Ten Americans die each day while awaiting an organ transplant, and the problem is becoming more severe. Between 1988 and 1994, the median waiting time nearly doubled (see Figure 1). It is imperative, then, that society find ways to increase the supply of organs, even through buying and selling. For most goods, prices are allowed to adjust to provide incentives, thus ensuring their most efficient allocation. While some people would understandably have qualms about the buying and selling of organs, the cost of our current approach is that shortages will remain endemic, and ultimately, *more* lives will be lost. Allowing monetary payments may not completely eliminate this shortage, but it will undoubtedly increase the number of organs available.

This paper examines the inherent difficulties of rationing by analyzing the market for transplantable organs. We look at the current procurement and allocation system and discuss various proposals to increase the efficiency of the market. Although the particulars of this market are unique to organ transplantation, society faces similar choices whenever prices are regulated and shortages occur. As Dr. Arthur L. Caplan, director of the Center for Bioethics at the University of Pennsylvania, notes, "It [organ transplantation] is a case study of rationing. It is of fundamental interest to every American. All of us will have to confront the decision of what is fair in the allocation of scarce resources. This is a canary in a mine that all of us will have to enter" (Kolata 1996: A1).

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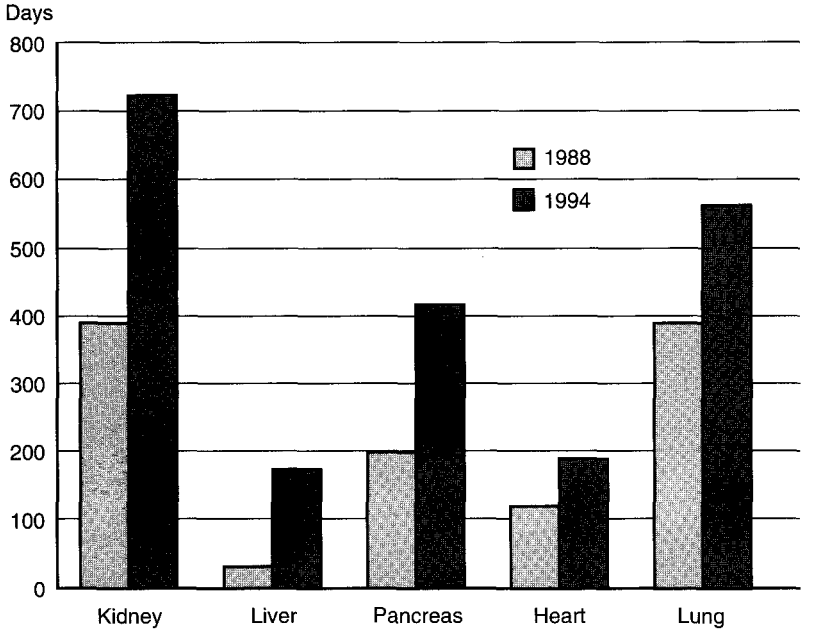
FIGURE 1

MEDIAN WAITING TIMES, 1988–94



SOURCE: UNOS (1995).

Rationing of Organs: The Current System

In 1984, Congress passed the National Organ Transplant Act, which outlawed the buying and selling of internal organs.[2] The National Task Force on Organ Transplantation recommended to Congress in 1986 that organ donation remain purely voluntary, governed by the altruism of the donor or the donor's family. Additionally, it suggested that the "selection of patients for transplant not be subject to favoritism, discrimination on the basis of race or sex, or ability to pay" (U.S. House of Representatives 1991: 44). This nondiscriminatory clause is crucial, because when prices are regulated and shortages occur, goods must be rationed. Since discrimination is one form of rationing, it is

[2]Specifically, the law prohibits the selling of organs if the transfer affects interstate commerce. Therefore, states may allow payments for organs, as long as the organs stay within state boundaries. However, given the current distribution system, states find it problematic to allow the selling of organs. Thus, the 1984 law has effectively prohibited a market in transplantable organs.

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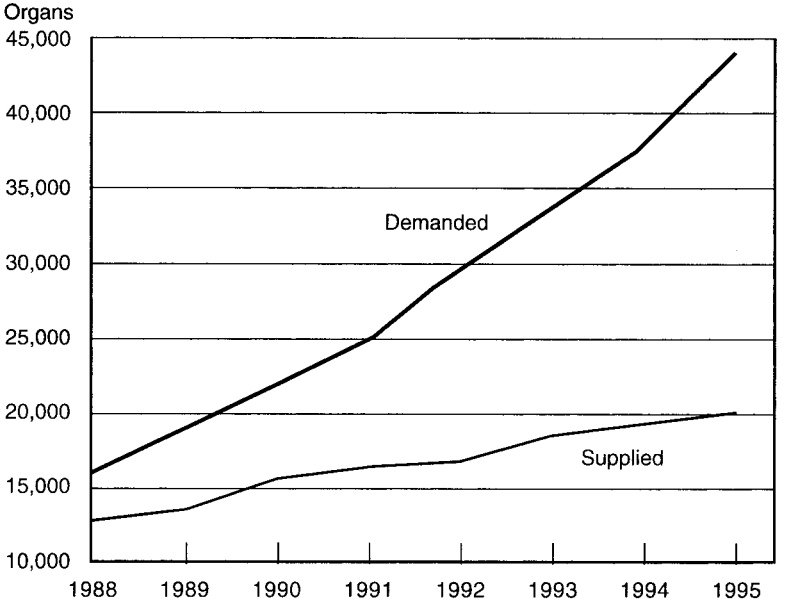
costless when markets are not allowed to operate freely.[3] In contrast, in an unregulated market, individuals and firms must forgo profits if they wish to discriminate—that is, engage in nonprice rationing.

Another concern was that political clout would influence the allocation process; hence, an independent nonprofit organization was selected to operate the Transplantation Network under the auspices of the Department of Health and Human Services. In October 1986, the United Network for Organ Sharing (UNOS) was awarded this federal contract. The group's task is twofold: establish criteria that match donors with waiting recipients, and develop policies that facilitate the procurement of organs. Figure 2 illustrates that within the current voluntary system, UNOS has been largely unsuccessful in increasing donations; supply increases have been minimal compared to demand. The major difficulties in devising an equitable organ distribution system are summarized in Table 1.

FIGURE 2

ORGANS SUPPLIED AND DEMANDED, 1988–95



SOURCE: UNOS (1996).

[3]There may be social costs associated with discrimination, but it is costless for the individual firm.

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TABLE 1

ORGAN RATIONING SCHEMES

Allocation Methods	Benefits	Costs
Waiting time	Equitable	Inappropriate matching; organ wastage; no consideration of urgency
Priority to sickest first	Equitable	Higher retransplantion and death rates; less benefit overall
Priority to sickest last	Higher overall survival; less retransplantation	Sickest patients die
Best biological match	Higher overall survival; less retransplantation	Fewer transplants for certain groups, including highly sensitized patients and some minorities

SOURCE: UNOS (1977a: Appendix D).

The Sickest-First Policy

Many contend that in a fair system, organs would be given to those who "need" them the most—the so-called sickest-first policy. UNOS uses this strategy in ranking liver and heart patients as part of its policy of minimizing patient deaths. The approach is myopic, however, since it ignores the impact that today's decisions have on the number of deaths over time.[4] The Mickey Mantle case is a stark example because Mantle, and hence his liver, died two months after surgery. Indeed, the two-year graft (organ) survival rate for patients who are in intensive care prior to their liver transplant is approximately 50

[4]A similar tradeoff exists during wartime with the triage of combat victims. This system maximizes overall survival by allowing the most critically ill soldiers to die.

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percent, compared to 75 percent for those who are still relatively healthy. These groups' individual two-year survival rates differ by 10 to 15 percentage points (UNOS 1997a).

Given the differences in two-year survival rates, the cost of transplanting 100 fewer livers into intensive-care patients today would be a loss of 85 to 90 lives versus 100 over a two-year period.[5] Since graft survival rates are higher for healthier patients, the number needing retransplantation would decline. Thus, another benefit of this one-time policy change would be to free organs for others. Another advantage is that by transplanting livers into healthier individuals, the number of critically ill patients would decrease, thereby saving additional lives. On net, this policy change would be more efficient because it would save more lives.

The Best Biological Match

Another allocation method (the one emphasized for kidneys) is biological matching, which is measured by the quality of the antigen match between donor and patient.[6] Once a kidney becomes available, UNOS searches among waiting-list patients and ranks them according to their biological match with that organ. When four of the six most critical antigens match, the one-year graft survival rate is 13 percentage points higher than for a total antigen mismatch. Four years later, that difference increases to 20 percent (Opelz 1988).

Instead of biological matching, waiting time alone could be emphasized—the first-come, first-served approach.[7] While this may seem more equitable, the cost of such a policy change would be enormous. In the first year alone, the average biological match would decrease by nearly three antigens, and graft survival rates would fall by about 6 percentage points. Even discounting subsequent declines in graft survival rates, the number of kidney transplant candidates eventually would increase by nearly 5,600, translating into approximately 202 more waiting-list deaths each year.[8] The importance of graft survival is obvious, given that nearly one-quarter of those on the kidney waiting list have received a transplant previously.

Despite their emphasis on biological matching, UNOS distributes kidneys on a regional basis, mandating that kidneys procured within

[5]This assumes that all intensive-care patients would die within two years without a transplant.

[6]Biological matching is not considered for livers and hearts because of time constraints. Ordinarily, when transplanting kidneys, a patient's health status is not considered given the alternative of dialysis.

[7]Currently, UNOS gives only slight priority to waiting time.

[8]Estimate is based on authors' calculations.

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a region stay local.[9] If, on the other hand, kidneys were distributed nationally, the pool of potential recipients would increase, thereby increasing the likelihood of finding a patient with a good antigen match. Thus, distributing kidneys nationally would expand the average biological match. This policy change not only would save lives, but also would eliminate inequities caused by regional variations in waiting times.[10]

Discrimination in Kidney Allocation

Certain groups of patients wait longer than others for kidney transplants and, because of equity concerns, are given special consideration. For example, highly sensitized patients are much more likely to reject an organ transplant because of antibodies acquired from multiple blood transfusions or from rejecting a previous transplant. UNOS gives them preference when a kidney is found that will not necessarily be rejected; otherwise, they may never be transplanted. Giving highly sensitized patients preference can be extremely costly, however, because it reduces the size of the waiting-recipient pool searched. In effect, UNOS limits its search to the prioritized group unless a match outside the group is considerably higher. Thus, the likelihood of finding a well-matched kidney decreases, along with patient and graft survival rates. Since highly sensitized patients make up less than 3 percent of all kidney patients awaiting transplants, discriminating *for* them is likely to cost more than if the group receiving preference were larger.

An even greater preference is given to patients with type-O blood. Although organs from donors with type-O blood can potentially be transplanted into patients with any blood type, transplant candidates with O blood can receive only an organ of the same type. Thus, to ensure that these patients' waits are not substantially longer, UNOS mandates that kidneys from O donors will go only to O patients, with the exception of perfectly matched kidneys. The cost of this policy is that potentially good matches are forgone.

Other groups, such as blacks, also spend a disproportionate amount of time awaiting transplants. The median waiting time for black kidney patients is twice as long as it is for whites. This has led many to conclude that UNOS's policies are inherently racist and that blacks should receive preference similar to that given to highly sensitized patients. The longer waiting time, however, is not due to discrimination

[9]The exception is if an individual with a perfect match is identified in another region. For a review of public policies to procure and allocate kidneys, see Singer (1990).

[10]There are costs involved in distributing organs nationally, because of increases in ischemic (preservation) time. These costs are small for kidneys (Opelz 1988), but large for other organs such as hearts. The feasibility of distributing livers nationally is currently being debated.

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but to a disproportionate number of blacks who suffer from hypertension and diabetes—the two major causes of kidney failure.

Blacks represent 29 percent of all patients with end-stage renal disease, while they make up only 12 percent of the population and donate less than 12 percent of all kidneys. These numbers are important because the quality of the biological match is usually better when both the donor and the recipient are of the same race. The fact that blacks demand more kidney transplants as a share of their population and that the supply of kidneys from blacks is, if anything, slightly less than this figure explains the wide discrepancy between black and white waiting times.[11] Thus, a policy change giving preference to blacks not only would be more inefficient, costing additional lives, but also would violate UNOS's directive not to discriminate.

Encouraged Volunteerism: The Need for Incentives

Changes in the way UNOS rations organs can potentially decrease waiting times and save lives, but major reductions in waiting-list deaths, and thus improvements in efficiency, will require a substantial increase in organ donations. Table 2 shows the gap between the number of available organs and the number of people who need a kidney, liver, pancreas, heart, or lung transplant. Although the shortages vary, most

TABLE 2

U.S. ORGAN WAITING LIST AND TRANSPLANT STATISTICS

Organ	Quantity Demand (as of 12/25/96)	Quantity Supply (January–December 1996)
Total kidney	36,013	11,949
Cadaveric		8,560
Living		3,389
Liver	7,467	4,058
Pancreas	1,786	1,022
Heart	3,935	2,381
Lung	2,546	844

NOTE: Multiple organ transplants are counted as more than one organ.
SOURCE: UNOS (1997b).

[11]Nevertheless, many argue that steps should be taken to end "discrimination." As a result, the number of black transplant coordinators has been increased in an effort to ensure that blacks have equal access to transplants. Not surprisingly, these efforts have failed. For several good articles investigating the extent to which discrimination is present in kidney allocation, see Eggers (1995), Held (1988), Kasiske (1991), and Kjellstrand (1988).

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of them are critical and have shown little response to public awareness programs, professional education efforts, or legislation. "Routine inquiry" laws, for example, require hospital personnel to inform the families of potential donors about their option to donate. In fact, doctors still mention this opportunity only two-thirds of the time.[12]

Trading Organs

The only way to increase the supply of organs is to increase the number of cadaveric organs, with the exception of kidneys, for which there is also the possibility of living donations.[13] More than one-quarter of the 11,700 kidneys donated each year come from living related individuals—an impressive number considering that kidney removal requires the donor to be hospitalized for five to seven days and to spend two to three months convalescing.[14]

What can be done to further increase the supply of kidneys from living donors? Currently, only 7 percent of these donations are from nonrelated individuals (primarily spouses), mainly because kidneys from nonrelated donors are usually poor matches or of the wrong blood type. To increase donations, UNOS could facilitate the trading of kidneys, allowing patients to receive a well-matched kidney in exchange for a kidney from a spouse or close friend. This policy would increase kidney donations from both related and nonrelated sources. For instance, a patient's relative or spouse may be willing to donate a kidney, but because they have the wrong blood type, they are not suitable donors for that individual.[15]

Financial Incentives

Although altruism can be a powerful factor in motivating organ donations, it works best within families and cannot be expected to function as efficiently in the market for cadaveric organs. Individuals may sign anatomical donor cards indicating their wishes, but in prac-

[12]One reason for the law's failure is lack of enforcement. There is a remarkable belief that monitoring is unnecessary. One staff member from Oregon's Health Department expresses it this way: "In a small state one does not need to coerce people to comply, especially with a requirement that is perceived as good policy" (Anderson and Fox 1988). For an editorial advocating this legislation, however, see Prottas (1988).

[13]Recently, however, doctors successfully transplanted a segment (lobe) of liver from a living donor.

[14]A new laparoscopic procedure could reduce the recovery time from two to three months to two to three weeks ("Laparoscopic" 1996). Doctors and ethicists are divided over the ethics of allowing living kidney donations (Levey 1986, Spital 1988).

[15]UNOS's procedures do allow for the trading of cadaveric organs. For example, when one region receives a perfectly matched kidney from outside the area, UNOS requires that the receiving region eventually reimburse the sending region with a payback kidney.

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tice, procurement agencies will remove organs only with familial consent. Thus, to increase supply, it is necessary to provide families with additional incentives. This is especially true given the relatively few deaths (10,000 to 12,000 annually) that occur in such a way that the deceased's organs are suitable for transplantation (UNOS 1993).

To increase donations, we need to consider financial incentives mimicking those that prices provide in a market economy. Perhaps the simplest approach is to give tax incentives to families who agree to donation. Donated organs already go to UNOS, a nonprofit organization; therefore, a monetary value would need to be assigned to organs only for tax purposes. To significantly increase the donor pool, society should also reconsider its position against the buying and selling of cadaveric organs. Allowing payments to surviving family members is another way of providing market incentives.[16]

To operate efficiently, the structure of this market would still require a centralized agency like UNOS to facilitate the matching process. Donor and recipient information is critical, since an individual's willingness to pay would depend on the quality of the antigen match with the available organ. One possible market structure would be to grant authority to buy and sell organs exclusively to the federal government, an approach suggested by Nobel laureate Gary S. Becker (Becker 1997).

Shifting Rents

A common misperception about situations in which goods are not allowed to be bought and sold is that their market value is zero. An unintended consequence of price restrictions, however, is that the quantity supplied falls and the good becomes extremely valuable. To take advantage of the difference between the regulated price and the market's valuation, black markets tend to develop. Even if the price of the good does not rise, the actual cost may increase because of queuing costs, as in the case of gasoline price controls.

Black markets for transplantable organs have not developed in the United States, but it is possible that the price of transplants is higher, because organs cannot be legally sold. The law allows for "reasonable payments" to all who participate in the organ donation process (U.S. Congress 1984). The ambiguity of this term provides an opportunity for

[16]The extent to which payments would elicit donations is unclear. The answer will likely come from pilot programs, such as the one recently introduced in Pennsylvania. Residents are offered the opportunity to contribute one dollar to a "Donor Awareness Trust Fund" when they renew their drivers' licenses or complete their state income tax forms. Up to 10 percent of this fund (a maximum of $3,000) can be redistributed to families of deceased donors for hospital, medical, and funeral costs (Dejong, et al. 1995; Eshleman 1994).

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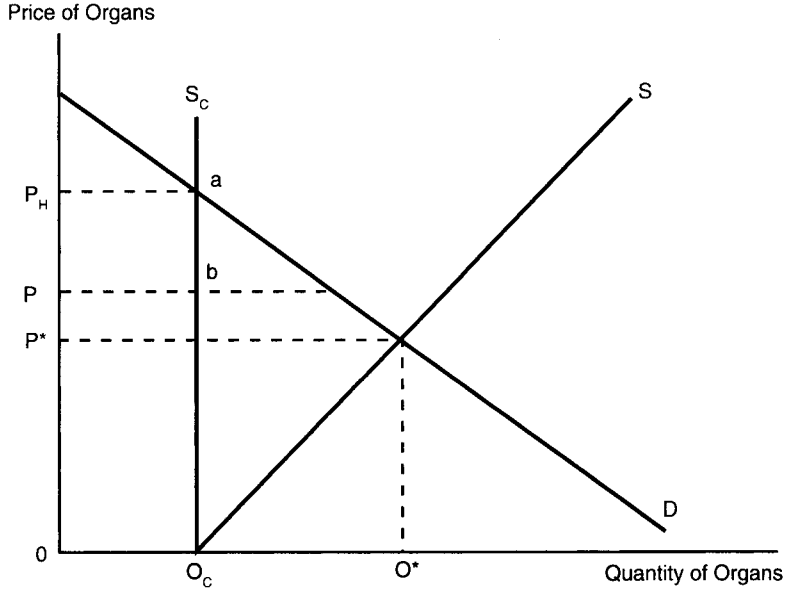
organ procurement organizations (OPOs) to artificially inflate prices. Currently, they receive approximately $25,000 for retrieving just the kidneys from a cadaver. An interesting, but as yet unresolved, question is how much of this $25,000 includes an implicit market price for the organ.

Other medical personnel (transplant surgeons, hospitals, etc.) also benefit financially from the organ procurement process, and are probably collecting some of these profits, also known as rents. Rents accrue whenever the quantity of a good is artificially restricted, thereby giving organizations monopolistic power. In the case of organs, the price, not the quantity per se, is restricted; however, the net effect is the same. Because of this, the shadow price (value) and hence the amount collected are likely to depend on the relative scarcity of the organ. Liver transplants are among the most expensive transplant surgeries—$300,000 on average—and as Table 2 indicates, livers are in especially short supply.

Figure 3 illustrates this concept in the market for transplantable organs, where S_c represents the supply of organs under the current

FIGURE 3

THE MARKET FOR TRANSPLANTABLE ORGANS



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system, and P_H represents the price that would clear the market.[17] This is the highest price, over and above normal fees, that a hospital can potentially charge for a transplant. Area $0P_{II}aO_c$ shows the maximum rents that would be collected.

It is clear, however, that all of these rents are not being collected, given current shortages. Yet, it is equally clear that some rents are being collected. For example, it is particularly telling that OPOs keep procured organs in their local area, even though UNOS's policies sometimes dictate otherwise. This is frequently true when OPOs are affiliated with hospitals' transplant centers (Caplan 1992), in which case the potential profits of keeping organs in-house can be substantial. Thus, there is an implicit market price, P, between zero and P_{II} that is being charged. At that price, the value of rents would be area $0PbO_c$. If P is above P*, as shown, then selling organs would actually lower the total price of a transplant (including the equilibrium price of the organ, P*). Similarly, if P is below the market-clearing price, the total price of a transplant would increase by less than P*. Thus, allowing organs to be sold would increase their supply, lower their market value, and shift payments from OPOs, hospitals, and surgeons to family members.

Even if the price of transplantation did rise by the full amount of P*, the money going to donors' families ("death benefits") would likely pale in comparison to the overall price of the operation. Consider the case where the family benefit is $5,000 and rent shifting does not occur. When allocated among two kidneys, a heart, liver, and pancreas, the extra cost per organ is probably closer to $1,000, an insignificant amount compared to the price of a transplant.

Equity Issues

Selling organs would not favor the rich at the expense of the poor, as many argue, since those receiving organ payments would likely have lower average incomes. Organ recipients, both rich and poor, would also benefit from the increased supply of organs. Currently, Medicare pays for kidney transplants, while 90 percent of liver and heart transplants are covered by Medicare, Medicaid, and private

[17]Actually, the notion of market-clearing in this market is ambiguous. By convention, an organ shortage is defined to occur when the quantity demanded (as measured by waiting-list patients) exceeds the annual supply. At any point in time, however, the quantity of organs demanded will exceed the available supply, even in a free market. Effectively, the relevant time frame for market-clearing should be organ-specific and should depend on the mortality rate of those awaiting transplants.

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insurance.[18] Each additional organ supplied benefits everyone, regardless of wealth.

Repealing the prohibition against the buying and selling of organs could lessen the disparity between black and white waiting times for kidneys. Because the antigen match is usually higher for individuals of the same race, any policy change that increases the percentage of black donors from its present level of 12 percent will decrease their waiting time. Thus, organ payments are more likely to persuade people of lower average income, including blacks, to donate, even if the payment amount is the same across all groups.

Given the higher demand for kidneys from black donors, in the absence of nondiscriminatory laws, payments to individual black families would likely be higher than payments to whites. But even without government assistance, this would not aggravate income inequality, since the extra amount paid by blacks would largely go to blacks. Given that Medicare (and frequently Medicaid) pays for kidney transplants, if anything, income inequality would be reduced by allowing organs to be sold.

Budgetary Concerns

Budgetary concerns are also misplaced. As previously noted, buying and selling organs may not increase transplantation costs at all, and even if it does, this policy change would still save Medicare money. It costs Medicare more than $40,000 annually to dialyze each kidney patient, while the cost of a transplant and subsequent medication is about $100,000 the first year and $12,000 per year thereafter. Because of this, the Health Care Financing Administration estimates that transplantation is considerably more cost effective than continued dialysis (UNOS 1997a).

For example, if the average life of a transplanted kidney were only three years, the budgetary impact of organ payments would be neutral. The median graft survival rate, however, is closer to six years. Therefore, as long as the family benefit is less than $180,000 ($90,000 per kidney), the government will save money. Since the vast majority (nearly 70 percent) of all waiting-list patients are waiting for kidneys, each additional dollar spent encouraging families to donate will save taxpayer money.

Conclusion

Rationing is considered anathema to most Americans, yet it is necessary when prices are regulated. Goods are frequently rationed

[18]Medicare covers almost all kidney recipients and pays 80 percent of expenses. The remaining 20 percent is picked up by either private insurance or Medicaid.

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by simplistic methods such as lotteries or first-come, first-served. These may be more "equitable" approaches, but they are also among the most inefficient and can ultimately harm everyone involved. The inefficiencies are particularly pronounced in the market for transplantable organs, where costs are measured in human lives.

Deciding what is fair and who should be first in line for organ transplants is especially troubling and difficult. Dr. Mark Siegler, who directs the University of Chicago clinical ethics program, has stated that "all alcoholics should go to the bottom of the transplant list . . . yet Dr. Siegler [also] said he would exempt Mickey Mantle from his rule because the baseball legend is 'a real American hero'. . . [W]e have got to take them with all their warts and failures and treat them differently" (Kolata 1995). It is especially important that UNOS resolve these issues given the current prohibition against the buying and selling of organs.

The cost of this prohibition is that lives are being lost. Additional incentives, including monetary, are required if cadaveric organ donations are to increase substantially. Even if these incentives do not eliminate the need for rationing, each additional organ procured will reduce the difficult, and sometimes arbitrary, decisions that UNOS must make. While many feel that the distribution of organs is too important to be left to market forces, ultimately, it is too important not to be.

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The Financing Corporation, Government-Sponsored Enterprises, and Moral Hazard

Keith J. Leggett and Robert W. Strand

After the Federal Savings and Loan Insurance Corporation became insolvent, Congress established the Financing Corporation (FICO) in 1987 for the sole purpose of financing a recapitalization of FSLIC. FICO issued over $8 billion worth of bonds over the next three years to replenish FSLIC; the bonds were to be repaid with funds from the Federal Home Loan Bank System and S&L deposit insurance premiums.

In 1995, public concern arose regarding the possibility of default on the bonds (see Wexler 1996). In May of that year, the Treasury Department and the Federal Deposit Insurance Corporation (FDIC) proposed a scheme to shore up the interest payments. That action, which was adopted by Congress in September 1996, set an important precedent by reinforcing the bond markets' belief that the federal government stands behind the debt of any private firm it has established. The persistence of this belief creates a "moral hazard" whereby all government-sponsored enterprises (GSEs) are relieved of bond-market discipline, and raises important questions about the cost and inefficiency of implicit federal backing. This paper examines the development of the FICO problem and addresses the public policy issues raised by the resolution of that problem.

The FICO Bonds

FICO was created by the Competitive Equality Banking Act of 1987 for the sole purpose of issuing bonds to finance a rebuilding of

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FSLIC. Between October 1987 and September 1989, FICO issued 14 series of debt obligations with an aggregate principal of $8.17 billion.

The FICO bonds were intended to be obligations of savings institutions rather than the federal government. The authorizing legislation clearly states:

> Obligations of the Financing Corporation and the interest payable on such obligations shall not be obligations of, or guaranteed as to principal or interest by, the Federal Home Loan Banks, the United States, or the Federal Savings and Loan Insurance Corporation and the obligations shall so plainly state.[1]

To assure that FICO bondholders are apprised of this fact, each bond carries a warning that is essentially a restatement of the legislative provision.[2]

Separate means were set up to pay off the principal and interest on the bonds. For the principal, $3 billion in capital was taken from the Federal Home Loan Bank System and used to purchase zero-coupon U.S. Treasury securities with maturities equivalent to those of the FICO bonds. For the interest payments, FICO was authorized to draw funds from the deposit insurance premiums paid by FSLIC-insured institutions.

Some of Congress' intentions in the 1987 law were not realized, however. First, the FSLIC rebuilding plan proved completely inadequate, so Congress had to act again in 1989 to close the fund and set up a new one—the Savings Association Insurance Fund (SAIF)—which is administered by the FDIC.[3] The FICO bond payments thenceforth were to come out of SAIF premiums instead of FSLIC premiums. Second, when the FICO bond funding scheme was devised, S&L deposits—the FSLIC-SAIF assessment base—were expected to grow by 7 percent per year, so that the FICO obligation would be a diminishing burden over time (U.S. General Accounting Office 1995: 14). Instead, the deposits did not start growing until the beginning of 1995.

An interpretative ruling by the FDIC involving deposit insurance premiums paid on Oakar and Sasser deposits further complicated

[1]Competitive Equality Banking Act of 1987, Section 302.

[2]Each bond states: "The bonds and the interest payable on the bonds are not obligations of, or guaranteed as to principal or interest by, the United States, the Federal Home Loan Banks, the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation Resolution Fund."

[3]The Financial Institutions Reform, Recovery and Enforcement Act of 1989 established the Resolution Trust Corporation to handle the remaining caseload of unsalvageable S&Ls. The SAIF did not commence full operations until the RTC's work was completed in July 1995.

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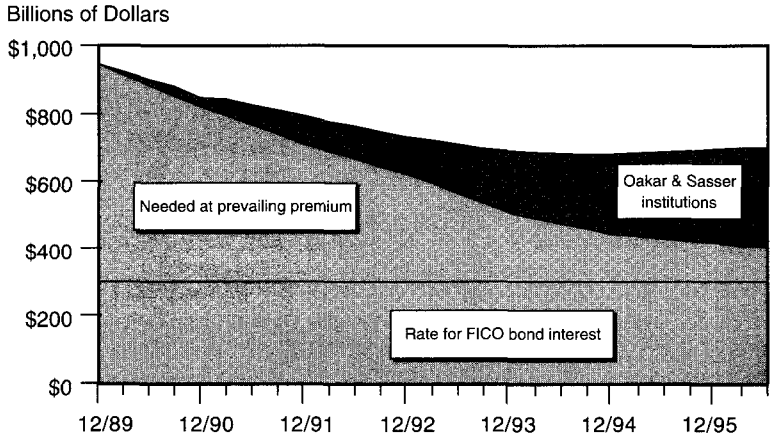
the picture. Oakar deposits are deposits that were once held by an institution that was insured by the SAIF, but were bought by an institution that is insured by the FDIC's Bank Insurance Fund (BIF), or vice versa. Sasser deposits are held by a SAIF-insured institution that has converted to a bank charter. While both Oakar and Sasser deposits remain SAIF-insured (by law), the FDIC interpreted the 1989 law to disallow deposit insurance premiums paid on those deposits from contributing to the FICO bond interest payments.

The Oakar and Sasser portion of the SAIF assessment base grew steadily after 1989 (Figure 1). These deposits amounted to $293 billion, over 40 percent of the SAIF assessment base, in June 1996.[4]

Non-Oakar/Sasser S&L deposits fell at an annual rate of almost 13 percent from 1989 through 1994. This steep decline was primarily the result of the efforts of the Resolution Trust Corporation (RTC), which completed the work of the defunct FSLIC by closing and selling off 747 unviable S&Ls with $403 billion of assets from 1990 through mid-1995 (RTC 1995: 1). With only two S&L failures in 1995, the annual rate of shrinkage dropped below 5 percent.[5] As of June 1996, the non-Oakar/Sasser assessment base was $445 billion, $112 billion

FIGURE 1

SAIF ASSESSMENT BASE



SOURCE: Federal Deposit Insurance Corporation (1996: 16).

[4]These and the following figures on the SAIF assessment base and non-Oakar/Sasser deposits were calculated from data provided by the FDIC (1996).

[5]Continued decline of S&L deposits was largely the result of competition from mutual funds and shifts in S&L funding to sources that are not assessed deposit insurance premiums, including Federal Home Loan Bank advances and repurchase agreements.

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above the level needed to cover the FICO bond interest at the prevailing SAIF premium assessment rates.

Legislative Protection of the FICO Bonds

This deposit growth history led to debates about the soundness of the FICO bonds. Some argued that the bonds would not be endangered at the 1995 pace of deposit growth, or if Oakar and Sasser premiums were allowed to help with the FICO bond interest. Others, however, saw the deposit declines starting in 1989 as indication that SAIF premium revenues could eventually become insufficient to cover the FICO bond interest. While assessment rates could have been raised in the event of a revenue shortfall, FDIC officials and others expressed concern that higher rates could have accelerated deposit declines.[6]

To shore up the FICO bonds, the Treasury Department and the FDIC developed a plan whereby BIF-insured institutions (primarily banks) would be asked to help pay the FICO bond interest. A variant of this plan was adopted in September 1996 when Congress passed the Deposit Insurance Funds Act of 1996. That law requires BIF members to share the FICO bond interest obligation with SAIF members; BIF members are to pay a FICO premium that is 1/5 that of SAIF members from 1997 through 1999 then equal thereafter.[7]

Should the FICO Bonds Have Been Protected?

The 1996 law—indeed the very fact that it was proposed—sets an important precedent. Federal officials stated publicly that the reason the FICO bonds had to be protected was to ensure that the bond markets would not become concerned about debt issued by other GSEs.[8] Thus, the initiative to fortify the FICO bonds confirmed bond

[6]See Fiechter (1995), Helfer (1995), and U.S. General Accounting Office (1995).

[7]The FDIC charged BIF members 1.3 cents per $100 (1.3 basis points) of the deposit insurance assessment base (domestic deposits with some adjustments) and SAIF members 6.4 basis points in annual FICO premiums in 1997 (in addition to deposit insurance premiums). The shared annual assessment rate is projected to go to 2.2 basis points for both BIF and SAIF members starting in 2000.

[8]FDIC Chairman Ricki Helfer said in testimony: "Related to the possible insolvency of the SAIF is the question of what would happen if the FICO bonds go into default. This is a subject of more direct concern to the Department of the Treasury, but the effects could be widespread. Among those effects could be downward pressure on the prices—and upward pressure on the interest rates—of securities issued by government-sponsored enterprises such as Fannie Mae, Freddie Mac, Farmer Mac, and Sallie Mae, which like the FICO are not backed by the full faith and credit of the United States" (Helfer 1995: 19).

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market suspicions that the federal government will also stand behind other GSE debt.[9]

This action created a classic moral hazard. Moral hazard occurs when a party does not bear the full costs of its actions; some or all of the costs are instead transferred to other parties. If the federal government is expected to cover any shortfalls, GSEs can pursue more risk-aggressive activities without the higher interest charges and bond covenants that normally would be imposed on them.[10] Thus, the costs of responsibility for added risk-taking are transferred to the federal government (and ultimately taxpayers) or whomever will cover any losses.

Not having to bear the full costs of risky projects encourages GSEs to accept higher risk and increases the chance that the federal government will be called on to make good on its implied guarantee.[11] The total scope of the contingent liability, the aggregate outstanding debt of all GSEs, was $949 billion as of July 1997 (Table 1), and it is growing fast—at an annual rate of 17 percent since 1991 (Figure 2).[12]

To limit the chance that the government might have to make good on its implicit guarantee, federal oversight agencies have been established.[13] The administrative costs of these agencies amount to a significant expense, the bulk of which comes out of taxpayer funds. In 1996, the Farm Credit Administration cost taxpayers $40 million, and the Federal Housing Finance Board and the Office of Federal Housing

[9]This is not the first indication that GSE debt is federally protected. In 1987, Congress bailed out the Farm Credit System to prevent its default, at an estimated cost of approximately $1 billion. In fact, the 1995 bailout of $17.4 billion in maturing *tesobonos* during the Mexican "peso crisis" by the United States and some international agencies indicates that the U.S. government may be willing to stand behind debt even in other, trading-partner countries—as is now evident in Southeast Asia.

[10]A publication from the U.S. Department of Housing and Urban Development (1996: 168) points out: "One basis for concern about the status of the GSEs has been that [implicit federal backing] has insulated them from exposure to 'market discipline.' That is, it is claimed that the GSEs have incentives to pursue riskier business strategies than firms in similar circumstances would have if governed more by market forces. It is feared that reduced market discipline could cause the GSEs to: set their capital/asset ratios low; manage interest rate and default risks less conservatively; and, during times of severe financial problems, pursue recovery strategies that involve additional interest-rate risk and default risk. If so, such business practices would increase the probability and severity of taxpayers' potential liability, should Congress elect to assist the GSEs if they should encounter financial difficulties."

[11]See U.S. General Accounting Office (1990).

[12]GSE debt and debt growth figures were calculated from data provided by the Board of Governors of the Federal Reserve System (1995: A33, 1997: A30).

[13]See Congressional Budget Office (1996).

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TABLE 1

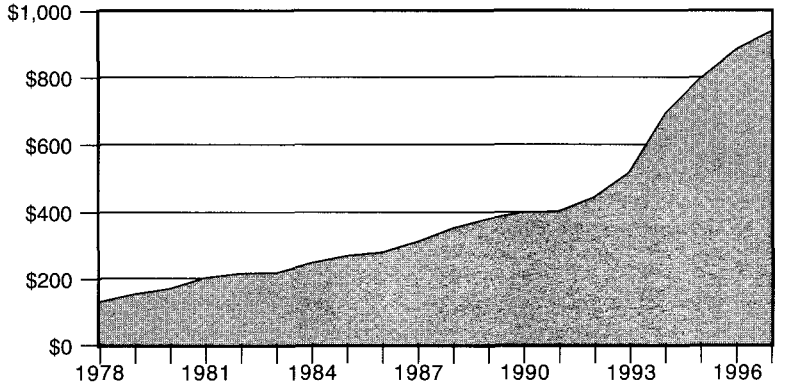
GOVERNMENT-SPONSORED ENTERPRISE DEBT
(AS OF JULY 1997)

Agency	Debt Outstanding (Billions of Dollars)
Farm Credit Banks	61.9
Farm Credit Financial Assistance Corporation	1.3
Federal Home Loan Banks	291.9
Federal Home Loan Mortgage Corporation	161.5
Federal National Mortgage Association	348.6
Financing Corporation	8.2
Resolution Funding Corporation	30.0
Student Loan Marketing Association	45.5
Total	948.8

SOURCE: Board of Governors of the Federal Reserve System (1997: A30).

FIGURE 2

GOVERNMENT-SPONSORED ENTERPRISE DEBT



SOURCE: Board of Governors of the Federal Reserve System (1997: A30).

Enterprise Oversight each cost $15 million (Executive Office of the President of the United States 1995: 538, 972, 992).

These agencies face a difficult task in trying to strike a balance between allowing GSEs to adapt to evolving market demands and yet restricting them from entering into overly speculative business activities. The agencies and legislators who oversee them have learned from the actions of the former Federal Home Loan Bank Board,

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which was abolished in 1989 after continually underestimating the magnitude of the S&L crisis. In today's political environment, regulators are encouraged to be cautious, inhibiting the ability of GSEs to perform their functions.

On the other hand, if no action had been taken to protect the FICO bonds, a totally different signal would have been sent to the bond markets. The markets would have been forced to assess the risk of the FICO debt, and similarly of all GSE debt. Because these markets are adept at assessing whether businesses are overly aggressive or foresightfully progressive—without a cautionary prejudice—and are also adept at imposing interest rates and bond covenants commensurate with risks, the market discipline imposed could provide unbiased and cost-effective supervision.

The timing of the adoption of explicit government support of the FICO bonds in 1996 also raises questions as to whether the appropriate party was the beneficiary of the legislation. The law provided a windfall gain for FICO bondholders due to the complete elimination of default risk. Therefore, the resultant lower interest rates on the bonds did not accrue to FICO itself. When an agency like FICO is established in the future, consideration should be given as to how its public purpose can be enhanced by up-front explicit federal backing. If federal backing is specified before an agency issues debt (instead of retro-fitted after the debt is outstanding), the benefits of a lower interest rate can accrue to the agency.

Who Should Support the FICO Bonds?

When Congress determined that it was in the public interest to safeguard the FICO bonds, the question was raised as to who should bear the cost of the bailout. The obvious suggestion was that if the public will benefit, then the public should pay through the federal budget. The legislation, however, chose to use private instead of public funds.

If private monies are to be used, then a fundamental principle of taxation would have those who receive benefits bear the costs. As noted earlier, the argument was made that the FICO bonds should be protected in order to assure market confidence in all GSE debt. If GSE debt is to be government-backed, then the GSEs should be charged in proportion to the benefits gained in the form of lower interest rates. If GSEs are not assessed for the implicit federal backing, they have a competitive advantage over fully private firms. That advantage inhibits the development of market-driven private industry that either does or could provide comparable services.[14]

[14]See Konstas (1995), U.S. Department of the Treasury (1996), and U.S. General Accounting Office (1996).

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GSEs could be assessed for the implicit federal backing in at least two ways. A system of cross guarantees could be established, whereby GSEs mutually guarantee each others' debt. The 12 Federal Home Loan Banks have this type of arrangement. Alternatively, a debt issuance fee could be charged to build a fund that backs outstanding GSE debt. For example, a guarantee fee is paid to the Farm Credit System Insurance Corporation for each debt issuance of the Farm Credit System. In the present case, user fees on GSE debt could be used for the FICO bonds.

The FICO legislation did not, however, assess any GSE. Instead, the banking industry was "asked" to share the FICO bond interest cost with the S&L industry. In fact, banks picked up 85 percent of the total burden. This arrangement is a second-order moral hazard whereby the federal government passed the cost of GSE protection on to banks rather than to the beneficiaries of FICO bond protection.[15] If this outcome is the consequence of the government offering implicit guarantees, then U.S. industry must be wary—in case the government is called on again to make good on an implicit guarantee, which industry will be obliged to pick up the obligation next?

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[15]Banks gained to the extent that they were among the holders of GSE debt. The chairman of the FDIC suggested that banks also gained indirectly from the increase in public confidence in federal deposit insurance after banks took over most of S&Ls' FICO payments so that more of S&Ls' deposit insurance premiums could go into the SAIF (Helfer 1995: 19–20).

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How Poverty Lost Its Meaning

F. Allan Hanson

After decades of dashed hopes and expenditures that have produced no tangible benefits, the nation seems tacitly to have acknowledged that we fought a War on Poverty and poverty won (see Sawhill 1988: 1085). Many see a brave title—the "Personal Responsibility and Employment Opportunity Act of 1996"—as merely papering over a wearied and frustrated withdrawal from the War on Poverty.

It has been possible to withdraw from the War on Poverty partly because the poor exercise very little political clout. They are a minority, many of them do not vote, and they do not otherwise participate in political life. Thus, when Congress was revamping poverty policy, the halls were empty of lobbyists arguing the case for the poor (Clymer 1996).

But, of course, the poor have always been relatively powerless. More importantly, the non-poor seem to have become less engaged in the issue of poverty, making it easier for politicians to dismantle federal welfare programs without antagonizing the middle and upper classes which constitute their power base. The deeper questions are therefore social and cultural rather than specifically political: Have the non-poor lost interest in poverty? If so, why?

My answer to the first question is yes, and, to the second, because poverty today has lost much of its meaning. In the past poverty signified something more than just economic destitution, and it was its larger significance that attracted the non-poor to the issue and motivated them to try to do something about it. Now the larger meanings have for the most part disappeared, leaving poverty as a drab, purely economic issue with little to excite the involvement of the non-poor. The purpose of this essay is to examine how this transformation came about, and to suggest a reason for it.

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The History of Poverty: An Overview

A brief sketch of poverty's history will throw its present form into sharper relief. The fundamental question about poverty has always been who or what causes it. Western thinking on this question has oscillated between placing the responsibility for poverty squarely on poor people and locating it in systemic conditions beyond the control of individuals. The distinction is visible in recent debates about why we lost the War on Poverty, with liberals adopting a systemic perspective and conservatives taking the individualist view. Their arguments contrast intriguingly with the reasons these same constituencies advance for why we lost the other, hotter war that we were fighting in Vietnam at roughly the same time. Now it is the liberals who espouse a Rambo-type philosophy that we lost the War on Poverty because we didn't fight hard enough and we lacked the will to win. Poor people are in their unfortunate condition due to circumstances beyond their control. Because the source of poverty lies in the socioeconomic system, the solution to it must also be at the societal level: large-scale interventions to rectify systemic inequities. But with the drastic cuts in social programs of the Reagan administration, those in the front lines were stripped of necessary resources and not allowed to press on to victory. The war on poverty was fought with popguns and ultimately it gave way to neglect and indifference (Quadagno 1994: 178, 197).

Conservatives counter that the war was misconceived from the beginning, born of misunderstanding of the situation and the nature of the adversary. They insist that poverty is at bottom an individual problem. Able-bodied poor should take responsibility for their own lives and extricate themselves from poverty by getting and holding a job. Large-scale interventions such as the government programs of the War on Poverty only make the situation worse by fostering dependence of poor people on handouts (Murray 1984: 218, Mead 1986: 65, Olasky 1992: 231).

Simple oscillation between systemic and individual causes is not sufficient, however, to capture the larger history of poverty. Since the Middle Ages each of the two basic points of view has dominated twice, but each moment had its unique characteristics. I will try to capture both the similarities and differences in the four versions of poverty with the following terminology: medieval piety, rugged individualism, state welfare, and contemporary individualism.

Medieval Piety

In the early Middle Ages the condition of poverty, or being "poor" (*pauperes*), was not necessarily defined in terms of economic destitu-

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tion at all. In England and northern France of the 9th and 10th centuries the category *pauperes* referred to free commoners: people who were neither nobles nor clergy. While they were certainly not well off economically, their most distinctive feature was that they did not bear arms. Thus, they stood in need of protection. This was the duty of the king and men at arms in France, while in England the king was bound to protect them against "knightly violence" (Mollat 1986: 95, 98–99, 296; Hyams 1980: 261–62).

Even as poverty became associated with economic hardship, it was not viewed as a social pathology. To the contrary, the poor formed an intrinsic part of an organic society, the three orders or estates of which—warriors, clergy, poor agricultural and other workers—were thought to reflect the order of heaven (Duby 1980: 3–4). Thus around the year 1000 people had a "mental image of a society one and triune like the divinity who had created and would ultimately judge it" (p. 5).

Given the divine origin of the social order, the poor were not held individually responsible for their condition. Prosperity and poverty alike were attributed to the grace of God, and all should accept their lot with humility. Nor were the poor stigmatized. If anything they were thought to be morally superior to the rich, particularly if they had voluntarily renounced secular wealth and power. Monks, nobles, and wealthy persons would wash the feet of the poor and invite them to dine. St. Louis, King of France in the 13th century, cut bread and poured drink himself for the paupers whom he fed at his own table. In a society that condemned this-worldly things, the poor represented a religious ideal. Moreover, they were downright useful to the rich and powerful as an outlet to atone for their sins through the Christian charity of alms-giving (Geremek 1994: 7, 17–20, 42; Waxman 1977: 73–77; Mollat 1986: 44).

Rugged Individualism

The transition to the next social construct of poverty was a lengthy one, not fully completed until the 18th or even the 19th century. Probably the process started when people began to attribute significance to the close link between poverty and unemployment, which began in the late 13th and early 14th centuries. This period experienced numerous poor harvests, famine, plague, severe winters, and bad times generally. Many peasants lost their land, and others were unable to support their families on their small holdings. These individuals formed a kind of rural proletariat that moved from place to place in search of work (Mollat 1986: 158–60). The numbers involved were large: in 1300 half the peasant households in England required outside wages earned by the family head to survive, and some 35 to 40 percent

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of the population of Europe could be classified as poor (pp. 168, 174–76). When no work was to be found the itinerant poor had few options other than begging and crime. The prospect of hordes of vagrants begging, robbing, and assaulting their way across the countryside inclined people, for the first time, to think of poverty as a social pathology. By the second half of the 14th century the image of the pious, meek pauper was undergoing a dark transformation. As Mollat (p. 251) describes it,

> More than ever there was a sharp contrast between the idealization of spiritual poverty and the visibly sordid realities of material poverty. . . . What did hideous tramps and fierce bandits have in common with Christ? How could people tolerate rebellion and violence against the established order and the will of God? What justification allowed able-bodied men to go begging, contrary to the natural law of labor?. . . . People were afraid . . . of the beggar's . . . idleness, his rootlessness, and his anonymity. They no longer knew with whom they were dealing.

The number of itinerant paupers increased greatly with rampant inflation in the 16th century, leading many municipalities to outlaw begging and almsgiving (Geremek 1994: 133–34, 146–47, 211). By this time the notion of poverty as a morally and spiritually superior state had long since been abandoned. The deserving poor (the aged, infirm, orphans, widows with young children) were distinguished from the undeserving poor (able-bodied paupers). While there was willingness to assist those in the former category, the undeserving poor were despised for idleness and moral debauchery, and they were subject to flogging and even death for infractions of the laws and decrees designed to restrict their wandering and force them to work (Waxman 1977: 95).

A second ingredient in the redefinition of poverty was the humanistic philosophy of the Renaissance. The image of the humble pauper had splendidly exemplified the medieval ideal of pious acquiescence in one's God-given lot in life, whatever it might be. It was totally at odds with the new humanistic emphasis on individual effort and aspiration, self-reliance and self-realization. From the perspective of those ideals, the able-bodied poor came to be viewed as incompetent, ludicrous, and dangerous human failures deserving neither self-respect nor the respect of others (Waxman 1977: 256).

A third ingredient, related to humanism, was the development of capitalism and the liberal political philosophy of the 17th and 18th centuries. The relation between the individual and society changed from an organic community in which groups were more important than individuals to a collection of independent, atomized individuals

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all pursuing their private interests and ordering their relations with each other by means of formal, explicit contracts (Kamenka and Tay 1975: 136–38). While an honored place had been reserved for paupers in the organic community of the early Middle Ages, they were useless, shameless drones in the context of the new values of individualism and self-reliance.

The fourth and final component in the transformation of poverty to be considered here is the notion that natural law decrees that the fit will survive and the unfit perish. An important corollary to this is that while the operation of this law may seem harsh, in the long run it works to the benefit of species and societies, and we interfere with it at our peril. This idea is of course most commonly associated with Darwin, and its application to social situations typically goes under the name of social Darwinism, but it actually emerged at least three-quarters of a century before *The Origin of Species* (Townsend 1971: 40–41; Malthus 1992: 14–15, 215–16, 227–30). From this point of view paupers belong to the category of the unfit and it might be better, as Ebenezer Scrooge said (in a work also written before Darwin's *magnum opus*), for them to die and decrease the surplus population.

With these four developments, the condition of poverty was utterly transformed from its representation in the Middle Ages as ideal piety and moral superiority. While there had been an intelligible—even honored—place for paupers in the organic, group-centered, medieval view of the relation between the person and society, poverty no longer made sense in the context of the newly ascendant humanistic and individualistic values. The unemployed, unambitious, dependent pauper was now seen as a contemptible anomaly. Poverty became a cancer on society, a cesspool of indolent misfits draining the resources of honest people who were willing to support themselves. Moreover, entirely in keeping with the individualistic ideology, responsibility for the bane of poverty was placed squarely on the poor themselves (Gans 1968: 202, Waxman 1977: 82–84).

State Welfare

The systemic view of poverty experienced the beginnings of a resurrection in the latter 19th century. The hallmark of this vision is the subordination of individual rights and interests to public policy and the public good, as these are articulated, planned, and administered by centralized, bureaucratic agencies (Kamenka and Tay 1975: 138–39). Briefly stated, this is the world of big organizations, big government, big bureaucracy, and thick volumes of administrative rules and procedures.

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With this transformation comes the assumption that social problems have systemic, societal causes and solutions. Elements of state welfare thinking are clearly visible in thinkers of the latter 18th and early 19th centuries such as Jean-Jacques Rousseau and Henri de Saint-Simon, but the first theorist to develop a systematic account of poverty from this perspective was Karl Marx. He proposed, as a basic characteristic of capitalism, that with the accumulation of wealth, the demand for labor also increases, but in a constantly diminishing proportion (Marx 1967: 629). Capital grows, that is to say, faster than the demand for labor. This inevitably produces unemployment, and those who are chronically unemployed are the paupers, "the dead weight of the industrial reserve army" (p. 644). The responsibility for poverty is thus to be found in the nature of the economic system, not in personal failings of poor people.

While medieval piety and state welfare share the notion that the cause of poverty does not rest with paupers as individuals, they are divided by several crucial differences. Most important, the theological basis of medieval piety gives way in state welfare to secularism, and assumptions about a rigidly hierarchical society are replaced with egalitarian ideals. Moreover, while in medieval thought poverty was an ideal condition, state welfare theory shares the rugged individualist notion that it is a problem to be solved—although by very different means.

An important component of the state welfare mode of thinking was the growth, since the late 19th century, of sociology and anthropology, for it is the stock-in-trade of these disciplines to analyze events more in terms of social systems and institutions than individual considerations. Of special relevance here is the "culture of poverty," introduced by anthropologist Oscar Lewis (1959). This is the idea that poverty is a whole way of life, marked not just by economic destitution but also by the absence of a prolonged and protected childhood, early initiation to sex, a low rate of formal marriage, frequent abandonment of wives and children, maternal dominance, and strong psychological feelings of marginality, dependence, and inferiority. The culture of poverty is resistant to change, because "by the time slum children are age six or seven, they have usually absorbed the basic values and attitudes of their subculture and are not psychologically geared to take full advantage of the changing conditions or increased opportunities that may occur in their lifetime" (Lewis 1968: 188).

This idea has important implications for the distinction between the deserving and undeserving poor. From the individualist perspective able-bodied paupers are to blame for their poverty and are undeserving of public assistance. But if, as Lewis claims, the culture of

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poverty reproduces itself in individuals by the age of six or seven, then it is unjust to hold them personally responsible for their inability to extricate themselves from their condition. While they may be able-bodied they are not "able-minded" or "able-cultured," and the ranks of the deserving poor should be expanded to include them.

Lewis worked largely in Third World societies, but in the widely read book *The Other America*, Michael Harrington (1962) applied the notion of the culture of poverty to poor people in the United States. He succeeded in sensitizing many Americans to the plight of those living among us who, through circumstances beyond their control, are condemned to lives of want and misery. Another influential work in the state welfare paradigm was *The Negro Family: The Case for National Action*. This confidential government report was prepared by Daniel Patrick Moynihan (1967), then assistant secretary in the Office of Policy Planning and Research at the Department of Labor, and submitted to President Lyndon B. Johnson in March 1965. It contended that the cycle of black poverty would not be broken so long as the pathological pattern of illegitimacy, divorce and desertion, and female-headed families remained in force. This report had a major impact on public policy, for the president relied on it in his commencement speech on black poverty, delivered at Howard University in 1965 (Katz 1989: 24).

These developments produced a sea change in thinking about poverty in the United States. According to Charles Murray (1984: 29), "What emerged in the mid-1960s was an almost unbroken intellectual consensus that the individualist explanation of poverty was altogether outmoded and reactionary. Poverty was not a consequence of indolence or vice. . . . It was produced by conditions that had nothing to do with individual virtue or effort. *Poverty was not the fault of the individual but of the system.*"

Many thinkers working within the state welfare paradigm—e.g., Robert Merton, Talcott Parsons, Charles Valentine, William Julius Wilson, and Michael Katz—deny that there is such a thing as a distinctive culture of poverty. The cause of poverty is an institutional structure that denies equal opportunity to the lower classes, often exacerbated by racial discrimination (Duncan 1968: 102–103, Fried 1968: 147–50, Thernstrom 1968: 176–79). From this perspective, the solution to poverty is to provide more opportunities for the poor, such as training, good jobs, or, simply, money. They can then be relied upon to exercise their own values (which are not that different from everyone else's) to take advantage of these opportunities and improve their situation. The extreme expression of this point of view came from a Johnson administration official, whom Marvin Olasky (1992:

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174) quotes as saying: "The way to eliminate poverty is to give the poor people enough money so that they won't be poor anymore."

Despite disagreements over matters such as the culture of poverty, state welfare thinkers are unanimous that poverty is not the fault of poor people. This view enabled poverty to regain a kind of respectability that it had lost under rugged individualism. The poor did not, of course, attain the integral and honorable position they had held in medieval piety, for the state welfare goal is not to acquiesce to poverty but to eradicate it. Still, to be poor became less humiliating. Poverty did not result from some individual aberrancy or failure, but from a flawed system. As victims of the system, poor people deserved not contempt but a helping hand.

And because the problem lay in the system, the solution to it must be to fix the system. That is a tall order. The only agency capable of designing and enforcing change in something so huge and sprawling as the overall socioeconomic system is government. Hence the centralized planning and administration, and the elevation of public policy over personal interests, that characterize state welfare thinking. This point of view dominated, of course, in communist countries, but it also prevailed in the social democracies of Western Europe. In the United States it informed the establishment of Social Security and the federal welfare system in the 1930s and, three decades later, it was represented in civil rights legislation, affirmative action, and the War on Poverty.

Contemporary Individualism

But, as was conceded at the outset, the War on Poverty was lost. The state welfare programs and policies did not work, and they came under fierce criticism. The worm has turned again and, in the last decade or so, a different version of poverty has emerged.

A common theme among authors who criticize the state welfare approach to poverty is that the Great Society programs designed to help the poor were not only ineffective but, in fact, have made the situation worse (Banfield 1974: ix, Mead 1986: 65, Murray 1984: 155–62, 218). Charles Murray develops the argument via the economists' model of decision-making by rational agents. Poor people, he posits, use the same calculus of self-interest that everyone else does. The problem is that, in their precarious circumstances, it is rational to orient toward short-term rather than long-term gains. Great Society programs designed as solutions to poverty actually create dependency on welfare because getting a job and trying to become self-sufficient produce no short-term advantage over relying on public assistance.

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Hence, the rational choice is to stay on welfare and avoid the drudgery of work (Murray 1984: 155–63).

The attitudes toward poverty fostered by the state welfare way of thinking also had detrimental effects. As we have seen, from that perspective poor people are not responsible for their poverty. Many of them learned that lesson so well that they "tended to view themselves as barred from work by lack of training, child care, transportation, and so on. They thought of overcoming these obstacles as government's obligation rather than their own. They could hardly imagine going to work without a government guarantee or protection of some sort" (Mead 1986: 65). Simultaneously, poverty began to shed its stigma. Prior to the 1960s it was humiliating to accept the dole, leading about half of those eligible for welfare to refuse it. The Great Society brought with it the contrary notion that the humiliation lay in doing low-paid work, and that one could maintain one's dignity by going on welfare (Olasky 1992: 168–69, Sandel 1996: 68).

Murray's proposal is to do away with virtually the entire federal welfare system. He would maintain a national unemployment insurance system to tide over those who have lost their jobs for a reasonably short period while they find another, and he would rely on private charities and municipal agencies to take care of the truly deserving poor who are incapable of work and have no family to support them (1984: 227–33). As for the able-bodied poor, Murray is unmoved by the argument that they deserve support because they fell into poverty due to circumstances beyond their control. In a passage that betrays an interestingly staccato concept of human experience, he writes: "people—all people, black or white, rich or poor—may be unequally responsible for what has happened to them in the past, but all are equally responsible for what they do next" (p. 234).

Murray seems unforgiving when compared with thinkers in the state welfare paradigm, but relative to other critics of the welfare approach his views are benign. With a collaborator, he has recently enunciated a vision of an organic society where everyone has a place, and all work—no matter how menial or poorly compensated—is dignified and confers an honorable place in society (Herrnstein and Murray 1994: 527–52). Other authors, such as Lawrence Mead and Edward Banfield, are more austere. Mead takes the stance of a hard realist. Abandoning any notion that all work is dignified, his remarkably Hobbesian account rejects the prospect that people will voluntarily take the dirtiest and lowest-paid jobs out of a motivation to support themselves and get ahead. We need policies to force them to work (Mead 1986: 13).

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Banfield tips his hand in the very first words of the Preface to *The Unheavenly City* (Banfield 1968: vii): "This book will probably strike many readers as the work of an ill-tempered and mean-spirited fellow." He hastens to assure us that he is really well-meaning and even soft-hearted, but that his work emerges from a staunch refusal to shy away from "the facts." As he sees them, the facts are grim indeed. There is no possibility to organize lower-class people to work for their own improvement because "the lower-class person (as defined here)[1] is incapable of being organized" (p. 130). Lower-class people don't mind the squalor of slum living; actually they like it. Nor is the lower-class person disturbed by the absence of libraries, parks, good schools. "Indeed, where such things exist he destroys them by acts of vandalism if he can" (p. 62).

The outlook is not hopeful. Banfield (1968: 258) sees little possibility of the lower class being absorbed into the dominant culture. So dedicated is he to the proposition that programs to alleviate poverty do more harm than good that he views it as a "frightening fact" that middle and upper class people want to donate their time and allocate money in an effort to solve the problem (pp. 253–54). The measures that Banfield is willing to countenance are made of sterner stuff: removing lower-class children from their parents either temporarily or permanently (pp. 229–37), and placing young lower-class males who have not (yet) broken any law under varying levels of surveillance, parole, or incarceration according to the probability that they will commit future crimes (pp. 182–84). Although written over a quarter century ago, *The Unheavenly City* continues to appeal to conservatives. As Robert J. Samuelson (1997: 49) writes: "The Banfield theory ignited outrage, because it meant that, beyond some point, the effort to end poverty would fail. In the prevailing climate—all problems were then deemed solvable—this was heresy. But it has stood the test of time and taps into popular ambivalence about social welfare."

Poverty Loses Its Meaning

Differences between contemporary individualism and its rugged precursor are less readily apparent than those between medieval piety

[1]Banfield's definition of the lower class has nothing to do with wealth. The exclusive defining feature is that a lower class person "is incapable of conceptualizing the future or of controlling his impulses and is therefore obliged to live from moment to moment" (Banfield 1968: 48). Thus, if you find someone whom you thought was lower class but who proves capable of organizing his or her efforts and activities for future benefits, the proper move in Banfield's logic is to say that person was not lower class after all, or is no longer. This preserves his view of the lower class as incapable of self-improvement, but at the cost of smuggling a good deal of tautology into the argument.

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and state welfare. Indeed, many recent accounts of the nature of poverty and what should be done about it initially seem indistinguishable from rugged individualism at its apogee in the 18th and early 19th centuries. The able-bodied poor are once again blamed for their condition; they are viewed as pitiful, even contemptible anomalies who lack the will and perseverance to sustain themselves. The concept of human nature has returned to the view of people as lazy and corrupt, willing to turn to productive labor only if circumstances require of it of them. Charles Murray's diagnosis that public welfare breeds dependence and should be abolished recapitulates with remarkable fidelity the proposals advanced in 1803 by Thomas Robert Malthus in his celebrated *Essay on the Principle of Population* (Malthus 1992: 228, 263–64, 266, 328; see also Malthus 1986: 9–10). Hardline views from Mead and Banfield about keeping the lower class in its place and forcing them to do menial tasks resonate with 18th-century opinions in Bernard Mandeville's *The Fable of the Bees* (Mandeville 1970: 294–95) and Joseph Townsend's *A Dissertation on the Poor Laws* (Townsend 1971: 35–36). Marvin Olasky makes such recidivist ideas explicit (Olasky 1992). He adopts an overtly Christian view of the corruptibility of human nature and recommends that policy toward poverty stress the tough love of uncompromisingly requiring work and moral improvement from the poor, just as our ancestors did from one to three centuries ago.

All these similarities tempt one to think that, state welfare having exhausted itself, thinking and policy about poverty are returning to rugged individualism. However, an anecdote from Olasky himself belies this conclusion and encourages deeper probing into what turn out to be quite fundamental differences between the rugged and contemporary varieties of individualism.

As part of his research on the condition of poverty, Olasky stopped shaving for a few days, dressed in ragged clothing, and joined the throng of the homeless in some of Washington's soup kitchens. In one of them, he asked a volunteer server for a Bible. It was necessary to pose the question twice before the person understood what was being requested, and then the answer came that no Bibles were available. That he raised the question is evidence that Olasky himself conceptualizes poverty in terms of the rugged individualist model; that he received the answer he did is evidence that, today, poverty for much of the rest of society has become something quite different.

In the 19th century, the Protestant ethic decreed that Christian living entailed sobriety, responsibility, and self-sufficiency. Those sunk in poverty were degraded spiritually as well as economically, and an important motivation for rescuing people from poverty was to save

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their souls. This attitude may still be found in the Salvation Army and store-front missions, but by and large, as Olasky's vain attempt to acquire a Bible demonstrates, the spiritual significance of poverty has disappeared.

Several other meanings associated with the rugged individualist view of poverty are also absent from the contemporary version. One of them is the Social Darwinist idea that nature's way of maintaining the health and well-being of a population or species is to weed out the least fit individuals. This notion was explicitly applied to the poor by Townsend, who argued in 1786 that whenever a population faces scarce resources, the weakest members will suffer and, if the situation is serious enough, die. This is the order of nature. Any interference with it, such as relief for the poor, will only "increase the number of unprofitable citizens, and sow the seeds of misery for the whole community; increasing the general distress, and causing more to die for want, than if poverty had been left to find its proper channel" (Townsend 1971: 40–1). Today this sort of explanation continues to dominate the presentation of other species on television nature programs, but it would cause instant outrage if it were advanced with reference to human poverty.

From the rugged individualist perspective poverty also provided insights into human nature, human civilization, and its progress. Malthus held that the two dominant human drives are for material comforts and sex. The latter causes population to increase faster than food production. Within limits this discrepancy is actually beneficial, for if food were easily obtainable man's natural indolence would deter him from hard work. But a population massively outstripping its food supply would suffer severe want and strife. Hence, it is necessary to control population growth. This is achieved by constraints on the sex drive; specifically, by delaying marriage and children until one is financially able to support a family. By encouraging industriousness, production, and the exercise of reason over base passion, these conditions stimulate economic and social progress and build individual character (Malthus 1992: 209–16; see also Montague 1886: 61).

Malthus continued that the poor do not understand these things. Placing no rein on their passions, they marry early and have many children. Thus, they unwittingly plunge themselves into destitution, and they fail to develop the finer qualities of character that come from self-control (Malthus 1992: 227). Hence, while Malthus favored abolition of welfare, he wanted to do this gradually and only *after* his primary proposal for solving the problem of poverty had been put into effect, which was to educate the poor. Once they realized that the cause of their poverty was their own profligate reproduction, most

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of them would mend their ways. This would have the multiple salutary effects of enabling present paupers to escape their poverty, preventing young people from falling into it, and turning them all into more productive citizens and more civilized human beings as they bring their animal drives under rational control (pp. 274–77, 328).

The larger significance of poverty is diminished in contemporary individualism. To be sure, the notion that destitute dependence erodes the character while responsible self-sufficiency bolsters it remains. It manifests itself in annoyance and impatience with people who cannot get and hold a job, who as unmarried teenagers place no restraint on their sexuality and take no responsibility for the children they produce. However, these sentiments are targeted at the poor as individuals and the link with the rise of civilization has largely vanished. Rugged individualism's virtue of controlling impulses and faith in social progress have both been devalued of late. Departing with them are the notions that what raises us above a brutish existence is voluntary, rational government of our natural instincts, and that precisely that self-control spurs the upward growth of civilization.

The difference emerges from a closer comparison of Murray's present proposal to end public welfare with the ideas proposed by Malthus nearly two centuries ago. Malthus' convictions about the value of controlling base passions and social progress are embedded primarily in his desire to educate the poor, and this part of his program Murray does not recapitulate. Indeed, where Malthus believed that the poor could escape their poverty if they were educated, Murray joins Richard Herrnstein in the very different view that limited innate intelligence restricts the degree to which the lower class can be educated (Herrnstein and Murray 1994). In this sense, contemporary individualism is leaner and meaner than rugged individualism for it sees fewer prospects for the poor to improve their state. And since better education is not likely to benefit the poor, given their limited intellectual capacity, the rest of society is justified in declining to allocate the resources to provide it for them.

The meanings associated with contemporary poverty are much reduced in comparison not only with rugged individualism but with medieval piety and state welfare as well. Medieval poverty represented much that was honored at the time: a Christ-like existence, pious renunciation of worldly things, humble acquiescence in what God had ordained, and an opportunity to seek divine favor through alms-giving. In the state welfare paradigm, poverty represented a challenge to the just and humane society that people were trying to build. The prospect of eradicating it symbolized what could be achieved in a Marxian utopia or a Johnsonian Great Society if only sufficient national will,

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expert planning and management, and community resources were devoted to the task.

The poverty of contemporary individualism has no meaning comparable to these. In its depressing self poverty denotes want, stagnation, and hopelessness. Its larger connotations are even more sordid: drug addiction, violence, and crime. Of course the non-poor would like to see all of these things come to an end. But that is no longer anything more than an end in itself. It is not linked to some shining image or transcendent crusade such as advancing civilization, saving souls, or creating a truly equal and just society. The motivation to commitment and self-sacrifice in the cause of ending poverty has gone slack, with the upshot that sufficient numbers of the non-poor no longer devote themselves to the task. Past failures seed their doubt that poverty can be eradicated, and present values do not provide them with any great incentive for continuing to try.

Discontinuity and Paralysis

If the contemporary view of poverty is distinguished from all three of its predecessors by the lack of a larger meaning, the critical question is why. My suggestion is that current notions about the nature of poverty foreclose all possibilities of doing something constructive about it. This contrasts sharply with the earlier conceptualizations of poverty, each of which included appropriate courses of action for dealing with it. This is not to say that what was to be done was in any sense easy. Supreme human effort was frequently required to respond properly to poverty, and there was no guarantee of success. It was precisely this challenge that sparked the aspirations and engagement with poverty of those who were determined to make singularly positive contributions with their lives. In the medieval view poverty was part of the order God had ordained for the world, and the proper human response was to acquiesce in it with humility. It cannot have been easy for the rich and powerful to demean themselves so far as to honor and serve the poor, and it was more difficult still voluntarily to renounce the world and its material rewards for the miserable life of a pauper. Yet these were powerful signs of Christian piety and devotion, and many strove mightily to embody them so that they might approximate in their own lives the highest values of their culture.

In the view of rugged individualism the cause of poverty was a natural order of society that had no tolerance for human ignorance and indolence. This too provided an opportunity and a challenge for activists who would work for the betterment of humanity. For Malthus it was to extend the benefits of civilization and education to the poor,

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and thus contribute to human progress. It is even possible that the temper of the time found a severe nobility in the flinty recommendations of Malthus and clergyman Joseph Townsend that the poor who had disdained the opportunity for self-improvement should be left (together with their innocent children) to die. This policy, they claimed, was inspired not by lack of compassion but by the conviction that to assist unregenerate paupers would transgress nature's (and God's) law and inevitably result in greater human suffering in the long run.

The state welfare paradigm also entailed a clear course of action for dealing with poverty. Since poverty is caused by a deeply flawed socioeconomic system, the solution is to reform the system. Again, while obvious, this is by no means easy. It asks those in privileged positions to forfeit much of their fortune for the sake of a more equitable distribution of wealth, it requires massive effort and expenditures by society at large to provide equal opportunity for all, it might even demand the sacrifice of partisans' lives in a violent Marxist revolution.

While each of the three earlier versions of poverty identified a meaningful, appropriate, and challenging response to poverty on the part of the non-poor, this is no longer the case. Today we agree that poverty is of human origin, stemming either from inequities in the socioeconomic system (for those who continue to hold the state welfare perspective) or from the shortcomings of poor people (for those of a contemporary individualist persuasion). But in either case, we have lost the conviction that, collectively, we can do much about it. Not because the obstacles seem more difficult to surmount than in previous epochs; I have argued, in fact, that the very difficulty of taking appropriate action regarding poverty was an important factor challenging people of those periods to devote themselves whole-heartedly to the task. The present situation differs from the other three in that, today, no appropriate course of action relative to poverty is readily apparent.

The reason for this, I suggest, is that contemporary culture has generated an unprecedented inconsistency. We think, on the one hand, that social reality is a human construct, but, at the same time, we doubt that human beings can exercise any significant control over it.

The first part of this proposition can be stated in weaker and stronger forms. Most people would assent to the weaker formulation, which is that the origins of our social institutions (capitalism, democracy, marriage, etc.) are to be found in human history rather than, say, divine ordination or natural law. The stronger version is more controversial, with a distinctly postmodernist ring. It is that we actively create our physical and mental habitats, forming them of artifice and

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simulation, and that these are just as "real" as anything else. As Ada Louise Huxtable (1997: 1) put it, "I do not know just when we lost our sense of reality or our interest in it, but at some point it was decided that reality was not the only option. It was possible, permissible and even desirable to improve on it: one could substitute a more agreeable product." Her specific reference is to architecture, but the same process has been recently observed in the formation of computer-generated virtual realities and online communities, political ideologies, the representation of the historical past and cultural traditions, and in countless other sectors of social life. Although the argument being developed here gains force with the stronger version of the human construction of social reality, it also can be run with the weaker, more generally accepted version.

The second part of the proposition—that humans lack significant control over our humanly constructed reality—is somewhat more esoteric. I will try to establish it first in the context of social theory, and then in the arena of practical life and popular thought. According to Steven Best and Douglas Kellner, one of the most important developments as social theory moved from structuralism through poststructuralism to postmodernism is the decline of humanism. Human beings, that is to say, have relinquished center stage. History and society are no longer seen as processes that move (or can be moved) in the direction of actualizing human potential and freedom, as was the case with Renaissance and Enlightenment thinking. Moreover, human beings are no longer seen as agents with the ability to influence the structure of society and the course of history (Best and Kellner 1991: 19–20, 24). One example of this shift is the debate between Louis Althusser and John Lewis over the driving force in the Marxian view of the historical dialectic. For Lewis, representing the earlier, Enlightenment tradition (one could also call it modernity), it is human striving to overcome bondage and alienation and achieve freedom, justice, and equality. Althusser, taking a poststructuralist perspective, insists that the engine of history is the class struggle perceived as a force in itself and quite apart from any human intentions or aspirations (Althusser 1976: 46–54).

Perhaps the most influential social theorist espousing a nonhumanist perspective on history and society is Michel Foucault. In *Discipline and Punish* (Foucault 1979), he argued that the evolution of "technologies of power" over the last three or four centuries should be understood not in terms of any human plan or intentions, but as the increasing self-actualization and perfection of Power understood as a thing in itself. Indeed, for Foucault the human subject is neither "transcendental in relation to the field of events' nor "runs in its empty sameness

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throughout the course of history" (Foucault 1984: 59), but is itself a product of a certain historical era. Moreover that era may be ending, and if that should happen "man" too may come to an end, erased "like a face drawn in sand at the edge of the sea" (Foucault 1970: 387). The reference here is not to "man" as a representative of a certain biological species, but rather to "man" as a social being, with certain attributes such as free will, individual identity, dignity, intelligence, political rights and duties, and so on. The nonhumanism of this position is explicit: the human individual is a construct of a certain sociocultural configuration, a particular historical moment. It is vulnerable to change or even extinction when that moment passes, rather than transcending and even guiding history.

The nonhumanism of Foucault and other contemporary social theorists has had a major impact on intellectuals. Their ideas may not have directly influenced society at large, but they may have filtered through in other guises. Be that as it may, parallel developments are discernable in the public sphere. Especially important is the 1994 election. This repudiation of the assumptions that underlay the New Deal and the Great Society was simultaneously a denial of the general proposition that, working together to make and implement policy, human beings can bring about intended effects to solve social problems and improve social conditions. Any such effort, so the thinking goes, is as likely to make the problem worse as it is to ameliorate it. Here public opinion concurs with Foucault and other nonhumanist theorists that human beings are not in control of their own affairs and that their corporate, intentional efforts to influence them are not likely to be effective.[2]

A similar message can be read in Robert Putnam's recent writings (1995, 1996) about diminishing social capital and civic engagement in American society. Putnam uses these concepts to refer to a general decline in social networks, trusting relationships, cooperation, and general connection of individuals with their communities. He notes that in the last 30 years participation by Americans in civic clubs and organizations has fallen by about 50 percent, and informal interaction with others through visiting and socializing has dropped by about 25 percent. While I think his identification of television as the culprit is oversimplified, his statistics documenting the decline of volunteerism

[2]One difference may be that public opinion is likely to hold that while concerted high-level efforts to effect change are ineffectual, individuals working privately or in small groups *can* influence issues in their private lives and localities. Nonhumanist theorists would probably recommend another turn of the screw, arguing that what motivates people in these matters are institutional and historical forces with trajectories of their own.

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and social engagement do represent compelling evidence for the proposition, paralleling that advanced above for the 1994 election, that many people in our society are losing faith in the possibility of concerted action to ease social ills or improve the quality of collective life. Hence, they turn inward—immersing themselves in their private lives and shunning the larger, public arena.

One of the darker sides of this development is the fact that a majority of states now have laws authorizing qualified citizens to carry concealed weapons. This reflects widespread loss of confidence in the ability of people in our society to live peaceably together and in the capacity of law enforcement agencies to protect citizens. Again the upshot is people turning away from public confidence and public institutions to a purely personal, private solution: I will arm myself because, ultimately, I can rely only on myself to protect myself and my family against the violent elements in society.

We are suspended in the disjuncture between the ideas that social reality is a human creation and that human beings, acting collectively, cannot control what happens in that reality. This impasse accounts for much in our current condition, including why poverty has lost its meaning. Poverty is clearly something of our own doing, but the non-poor are no longer moved to take concerted action to alleviate it. This is not because they think the solution is too difficult or expensive, but because they have lost confidence that any large-scale plan will work. They may, of course, lend assistance on a personal level, doing good in minute particulars. But the notion that this can be part of a program with more cosmic meaning, a program that promises to eradicate poverty for once and for all, founders on the apprehension that humans exercise very little control over the course of development of the social reality they themselves have created.

Not everyone, of course, is willing to live with this uncomfortable and paralyzing combination of ideas. Religious faithful who seek to tailor themselves to a God-given reality persist, as do social reformers who seek to tailor reality to a utopian vision. But if the growing indifference to poverty is any guide, it points to the conclusion that these groups no longer represent majority opinion or sway public policy. Those among the non-poor who are unmotivated to grapple with a problem for which they can discern no solution find it more bearable simply not to think about it. This choice includes ordering where they live, where their children go to school, what they read, and what they expose themselves to in such a way that poor people intrude minimally upon their lives and consciousness.

Actually, this strategy does entail a solution of sorts to the problem of poverty, and a remarkably clean and cheap solution at that: to make

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poverty disappear by the simple expedient of not acknowledging it. This is an especially compelling option if one adopts the stronger version of the proposition that social reality is a human construct. That view, it will be recalled, holds that social reality is the product of artifice and simulation. Things are as we say they are, a "virtual reality" extending well beyond our computer screens to encompass our entire social lives. As poverty theorist Michael Katz (1989: 7–8) has clearly recognized, poverty is not so much the existence of poor people as the prevailing discourse about them. It follows that if the prevailing discourse about poverty ceases, if people will just stop worrying and thinking and talking about it, then poverty itself will come to an end. Poor *people*, of course, will continue to exist. But they will no longer represent a social problem, just as leprosy ceased to be a social problem although lepers continued to exist.

If one chooses to take a less radical stance and insist that poverty has a reality of its own apart from what people may think about it, the outcome is not fundamentally different. Even if becoming indifferent to poverty does not alter its basic reality, it obviously does alter what is done (or, more to the point, not done) about it. American citizens of Japanese descent really were interned in concentration camps during World War II but little was done about the outrage until public attention focused on the issue decades later. In the same way, poverty may be a grim reality, but the loss of a larger meaning for it, and the resulting indifference among an increasing proportion of the non-poor, is what, more than anything else, enables legislators to end welfare as we have known it.

Epilogue

In the spring of 1997 President Clinton convened a domestic summit conference on volunteerism, with the aim of encouraging Americans to become more deeply involved in voluntary service. The outcome of that initiative constitutes an empirical test of the thesis of this essay. As of this writing it is too early to tell, but the somber prediction stemming from what has been argued here is that the president's effort will bear little fruit, at least in the area of volunteerism relative to poverty. The reason is that larger meanings necessary to stimulate people to enlist in the struggle against poverty are lacking. If this prediction is wrong and the president's initiative does result in significant numbers dedicating themselves to alleviate poverty, the thesis of this essay would be disproved. In that happy event, my expectation would be that some fresh set of meanings has emerged to motivate

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the new volunteers in the war against poverty. An important research question then would be to identify just what those meanings are.

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From Planning to Regulation: Toward a New Dirigisme?

Deepak Lal

In this article in honor of Professor B.R. Shenoy, the preeminent classical liberal Indian economist during the lost years of Indian planning, I will discuss the "new dirigisme" that is emerging even as there is a worldwide move from the plan to the market. The dirigiste impulse has not been stifled but merely transformed from planning that sought to supplant the price mechanism to regulation that seeks to supplement it. The intellectual basis for both sorts of dirigisme is the same. Planning being discredited by the events of 1989, dirigistes—spanning the political spectrum—have rallied around the banner of bureaucratic regulation to correct various forms of perceived market failure. These relate to externalities, in particular those relating to the environment, and to various forms of monopoly. Having dealt with the former elsewhere (see Lal 1994, 1995), I shall be mainly concerned with the latter.

This new metamorphosis of the dirigiste beast—in the form of bureaucratic regulation of the market—has plagued the United States since World War II. In particular, given the growing importance and shortage of infrastructure—and the inability to finance it through taxation—governments in both the Third and Second Worlds are being forced to examine private sector alternatives. As many aspects of infrastructure have the characteristics of natural monopolies, which current wisdom and past practice in the United States deem require regulation in "the public interest," its future development and regulation will provide the major operational arena for the new dirigisme.

The Mutations of the Planning Syndrome

Shifting Notions of Competition

The common intellectual basis for the justifications provided for planning and regulation is linked to a subtle but important shift in

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economists' notion of competition—from the classics, spanning Adam Smith to J.S. Mill, to modern mainstream economics. The latter's intellectual moorings are provided by the so-called Arrow-Debreu theory of general equilibrium, which it is asserted gives precision to the claims of the classics on the virtues of the market (see Arrow and Hahn 1971: vi-vii). But as Blaug (1987: 443) points out, one needs to note

> the subtle but nevertheless unmistakable difference in the conception of "competition" before and after the "marginal revolution." The modern concept of perfect competition, conceived as a market structure in which all producers are price-takers and face perfectly elastic sales curves for their outputs, was born with Cournot in 1838 and is foreign to the classical conception of competition as a process of rivalry in the search for unrealized profit opportunities, whose outcome is uniformity in both the rate of return on capital invested and the prices of identical goods and services but not because producers are incapable of making prices. In other words, despite a steady tendency throughout the history of economic thought to place the accent on the end-state of competitive equilibrium rather than the process of disequilibrium adjustments leading up to it, this emphasis became remorseless after 1870 or thereabouts, whereas the much looser conception of "free competition" with free but not instantaneous entry to industries is in evidence in the work of Smith, Ricardo, Mill, Marx and of course Marshall and modern Austrians. For that reason, if for no other, it can be misleading to label classical economics as a species of general equilibrium theory except in the innocuous sense of an awareness that "everything depends on everything else."

It is equally surprising that the "Chicago school," as Kirzner (1994: 103) has noted, "maintains that the competitive market economy displays systematic regularities only to the extent that it can be reasonably fitted into the perfectly competitive mold. Subsequent [to Frank Knight] generations of Chicago theorists would maintain that as a matter of fact the real world competitive market *can* so be fitted." Thus, self-proclaimed mainstream theorists on both sides of the market-dirigiste divide now use the Arrow-Debreu model as their paradigm.

From this theoretical perspective, the two fundamental theorems of welfare economics are derived, which theorists assert provides the justification for the superiority of a market economy (see Dasgupta 1980, Hahn 1984, Sen 1983). While if one or the other conditions for the existence of the utopian state of perfect competition are not

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Professor B.R. Shenoy Memorial Lecture, which he delivered in Ahmedabad, Gujarat in March 1996.

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met, there is "market failure" and thence a prima facie case for government intervention. This justification for dirigisme is bizarre (Lal 1983, 1987). To compare competition in any actual market economy with an unattainable ideal, is, to use Demsetz's (1969) useful phrase, a form of "nirvana economics." For it is child's play to show that because of incomplete markets, external effects, and the existence of public goods, "market failure" defined as deviations from the perfectly competitive norm is ubiquitous, but the corollary that this then requires massive corrective public action is highly dubious.

But "market failure" was the intellectual basis of the planning syndrome. As emerged in the famous debate between Lange, Lerner, von Mises and Hayek in the 1930s, the planners (Lange and Lerner) argued that (a) because of the ubiquitous imperfections in most markets, no market economy could ever in practice attain the utopian norm of perfect competition, and (b) through computations simulating the outcome of a perfectly competitive economy, the planners could compel the production of the resulting quantities of inputs and outputs (or legislate their optimal relative prices). A planned economy could, thus, achieve nirvana. Hayek and Mises pointed out that, though such a form of planning might be theoretically feasible in a world where information about resources, technology, and the myriad actual and possible production processes and tastes of consumers could be costlessly acquired by the central planning authority, in the real world it would be impossible. The market-based price mechanism is essential because it makes use of the division of knowledge which is unavoidable in any real world economy (see Hayek 1935).

The failures of centralized planning—not least in India—are now well known, with the events of 1989 having hopefully buried the planning syndrome. For even mainstream theorists accept that imperfect information leads to incomplete markets (see Greenwald and Stiglitz 1986, Dasgupta 1980, and Stiglitz 1994), which cause problems of what is called "incentive compatibility"—exactly the point made by Hayek and von Mises in the 1930s. Thus, a command economy on Lange-Lerner market-socialist lines is ruled out.

Neoclassical Public Economics

But it is being argued that a full welfare optimum or Pareto improvements can be achieved by the government implementing a system of optimal taxes and subsidies. This "optimal tax" basis for the new dirigisme is set out in Stiglitz (1994), and its theoretical base is claimed to be the working out of this optimal tax structure in Greenwald and Stiglitz (1986). Its relevance is however strictly limited. First, because its implementation raises questions both about the character of the

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mandarins required to implement these "optimal taxes," and second, because in a dynamic economy the optimal structure will have to be continually changing and the requisite information will not be readily available to the authorities, as Hayek (1945) noted a long time ago.[1]

On the first question concerning political economy, Greenwald and Stiglitz (1986: 234, n.7) note: "We ignore any discussion of the political processes by which the tax-subsidy schemes . . . might be effected. Critics may claim that as a result we have not really shown that a Pareto improvement is actually possible." Quite! While on their claim "that there exist Pareto-improving government interventions . . . [and] that the kind of intervention required can be simply related to certain parameters that, in principle, are observable" (p. 231), they are in their concluding comments forced to concede:

> We have considered relatively simple models, in which there is usually a single distortion (one kind of information imperfection, one kind of market failure). Though the basic qualitative proposition, that markets are constrained Pareto efficient, would obviously remain in a more general formulation, the simplicity of the policy prescriptions would disappear. Does this make our analysis of little policy relevance? The same objection can, of course, be raised against standard optimal tax theory. (Some critics might say, so much the worse for both.) Though simple expositions of optimal tax theory often focus on the case of independent demand curves, in the general case, one needs to know all the cross elasticities of demand, and these are seldom available. What is worse, if one abandons the unrealistic assumption of the standard optimal commodity tax formulation (e.g., Diamond-Mirrlees 1971, with their assumption of 100 percent pure profits taxes, no restrictions on commodity taxation, and no [progressive] income tax), then the informational requirements on the government are even greater [Greenwald and Stiglitz 1986: 258].

To those of us who misspent our youth advocating the Little-Mirrlees rules of second-best shadow pricing, the policy irrelevance of the new dirigisme is hardly surprising.[2]

[1]Stern and Newberry (1987) have advocated the application of this optimal tax theory to developing countries. But as they note, it assumes that "the government has coherent, unified and largely benevolent objectives, captured in the social welfare function, and we search for ways in which the tools available to it can be used to improve the measure of welfare" (p. 653). That the theory is irrelevant for most developing countries is patently obvious as most of their polities do not even come close to these assumptions about their character. While if a predatory state or rent-seeking society is accepted as likely, the optimal tax rules are no longer valid even within this framework (see Lal 1994: chap. 13). For a trenchant critique of optimal tax theory, see Harberger (1987), who moreover notes that it is based on a philosophy of government—the social-engineering view—which differs from that of classical liberalism.

[2]See Lal (1980) for one of these exercises in irrelevance, and Lal (1993: chap. 1) on how I came to eschew this public-economics approach to public policy.

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Market Governance or Business Governance?[3]

Many, however, have found the case studies of supposedly successful dirigisme in the Far East conducted by the "market governance" school more persuasive. It is undeniable that the trade and industrial policies of many of these countries were dirigiste. But was their undoubted success due to or despite this dirigisme? I.M.D. Little (1994), basing himself on estimates of social rates of return to investment for Korea, shows convincingly that they were inversely correlated with the degree of dirigisme. While the World Bank's 1993 *East Asian Miracle* study, which based its empirics on total factor productivity calculations, despite its circumlocutions, found that public interventions in both Korea and Taiwan had little effect in altering the structure of production at the sectoral level, and that the least selective intervention in these and other Asian miracle economies—the commitment to manufactured exports—was the most successful. Thus, despite the claims of the market governance school these economies vindicate policies of "getting prices right" rather than of getting them wrong.

Another more persuasive explanation can be provided for their industrial and trade policies (see Lal 1993). Following some insights of Demsetz (1995) concerning the problem of control of business enterprises, I have suggested that the explanation for the undoubted dirigisme to be found in Korea and Taiwan, for instance, is to be explained by the agency problem that a country faces when it moves up the ladder of comparative advantage—ordered by ascending ratios of capital to labor—into more capital intensive lines of production, where there are likely to be indivisibilities in investment. In the absence of private concentrations of wealth, ownership and control are likely to be separated in these industries, leading to an agency problem, as the interests of the managers who control the day-to-day operation of a firm and the owners who are concerned with maximizing the return to their "shares" diverge. The problem is one of maintaining beneficial control over resources when there are economies of scale and scope in a firm. This control is in turn related to the amount of private wealth that is required to reduce the degree to which ownership is separated from control of the relevant resources. Inequalities in private wealth may therefore be productive in allowing fewer people to own firms and exercise greater control over the managers than if

[3]The "new growth theory" (Romer 1986, Lucas 1988) and the "new trade theory" (Brander and Spencer 1984, Helpman and Krugman 1985) have also been used to support dirigisme, but their theoretical and empirical bases have not been found to be persuasive by either theorists or applied economists (see Solow 1994, Stern 1991, Pack 1994, Baldwin 1992, and Lal and Myint 1996).

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wealth and "shares" in the firm were more dispersed. This agency problem becomes important as soon as a country moves to the more capital intensive rungs of its ladder of comparative advantage. For at the lower rungs, given the small concentrations of capital required to set up enterprises, they can be owner-managed.

There are three ways of overcoming this agency problem. The first is through sufficient concentration of private wealth, and some institutional means for its spread over a number of enterprises while maintaining control by some concentrated owners. The second is through public enterprises. The third is through foreign equity controlling local firms.

Korea, following Japan, sought to create concentrations of private wealth through the promotion of the *chaebol*. The major instrument was long-term subsidized credit to a select number of industrial groups, who were chosen by a relatively efficient dynamic monitoring process based on export success—under a relatively neutral overall trade regime. But the resulting concentration of economic power has subsequently become a political albatross.

In Taiwan, by contrast, as the government was concerned with the political consequences of promoting native Taiwanese economic power, it eschewed the Korean route and instead chose the public sector route for capital-intensive industries like ship-building and petrochemicals; but with the usual damage to profitability as compared with the private sector alternatives (see Wade 1990: 81).

Singapore chose the third route, but its "neutral" trade regime ensured that the direct foreign investment was not of the tariff-jumping kind, and hence likely to be both socially as well as privately profitable (Lal 1975).

Finally, there is the laissez-faire example of Hong Kong. Whilst Singapore did try to force the pace at which its industries were to move up the ladder of comparative advantage (with some dire results as in its 1980s recession), Hong Kong let its industrial structure evolve more naturally. If performance is judged by the productivity of capital then Hong Kong has been the more successful (see Findlay and Wellisz 1994, Lal and Myint 1996, Young 1992).

A Counter Counter-Revolution in Development Theory?

This experience suggests that there is little merit in the new dirigiste case. So why has Krugman (1992) proclaimed a "counter counter-revolution in development theory?" Because, he claims, the ideas of the old development economics—based on the importance of increasing returns and pecuniary external economies that underwrote concepts like the "big push" in investment and "backward and forward

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linkages" in planning industrialization—have now been formalized and shown to be logically consistent. In other words, he claims that the reason the old development economics failed to persuade was because it did not use formal mathematical models to express its ideas. But that is ridiculous. As his discussant Stiglitz (1992: 41) rightly noted, "That we can write down a model of a phenomenon proves almost nothing. It does not make the idea right or wrong, important or unimportant." The reasons why the "big push" and "linkages" do not persuade were clearly set out in the detailed discussion by Little (1982). Murphy, Shleifer, and Vishny's (1989) formalization of a model does not in itself validate a big push in investment whose validity depends on the income effects associated with increasing returns—which are irrelevant in an open economy.

Moreover, we now have empirical evidence of the outcomes in countries that did try a "big push." Four were included in the Lal and Myint (1996) study—Ghana, Madagascar, Brazil, and Mexico.[4] The results were invariably disappointing if not disastrous (as in Ghana and Madagascar). To promote such bad policies just because some theorists have been able to write down some algebra is not only puerile but wicked, given the high costs that the poor people thus being experimented on suffer.

Regulating Monopolies: Toward a New Dirigisme

Monopoly and Competition

While the above debates are unlikely (I hope) to have any practical influence on the current worldwide move from the plan to the market, another more ancient debate concerning monopoly and how best to deal with it is likely to promote a new dirigisme.

Two Views About Monopoly

There is a popular view propounded by socialist thinkers like R.H. Tawney and embraced by many Third World politicians like Jawaharlal Nehru that a market economy will inevitably be dominated by monopolies. It continues to resonate, not least in many supposedly market economies. But is it right? An important paper by my UCLA colleague Harold Demsetz is useful in setting the record straight. As he notes, there have been two systems of belief about monopoly: one, due to Adam Smith, that sees monopoly as being necessarily underwritten by government action designed to keep potential rivals from competing; and one that views monopoly as arising naturally, without govern-

[4]Also see Lal and Maxfield (1993) for a detailed analysis of the Brazilian case.

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ment intervention, because of economies of scale. In this second case, the theoretical model of monopoly—in which there is only one firm in an industry, as compared with the atomistic case of perfect competition—has led to the belief that monopoly is significantly correlated with market concentration. But as Demsetz (1988a: 94) notes, "The monopoly model *assumes* that monopoly power exists, it does not explain *how* monopoly power is exercised and maintained." In particular, there is "no good explanation . . . provided for how present and potential rivals are kept from competing without some governmentally provided restrictions on competitive activities." The usual culprits, economies of scale, indivisibilities of capital, and advertising as sources of barriers to entry are acquitted while the empirical evidence in support of the view based on Bain's supposed demonstration of a positive correlation between profit rates and measures of market concentration is shown to be at best shaky if not nonexistent on the basis of more recent research.

A similar view, that the degree of market concentration does not imply that market prices and outputs will necessarily diverge from the competitive outcome, is also stressed by the recent theory of contestable markets (Baumol, Panzar, and Willig 1982). Even with scale economies which limit the number of firms that can service a particular market, as long as potential rivals can contest the monopoly, the single eventual incumbent's pricing and output policies need not diverge from those under competition. The only rent such a monopolist can acquire is in terms of the sunk costs of firm-specific assets essential for production.

All this suggests that, appearances to the contrary, the old Smithian view that monopolies ultimately depend on government support is valid. In the absence of such public protection, even in industries where only one firm survives, there is no necessary presumption that its behavior will be monopolistic.

This of course means that regulations designed to increase competition—such as U.S. antitrust legislation—are unnecessary. Worse, because of the evidence of the capture of the regulatory agencies by the companies being regulated (Stigler 1988), for well-known reasons of political economy, there is the clear danger that such regulations instead of promoting competition create the very government mediated barriers to entry which nurture monopolies.

The basic reason for this is that efficient economic performance does not only depend on one type of competition—the *imitative* output competition emphasized by perfect competition. Equally important is *innovative* competition, particularly of the creatively destructive kind emphasized by Schumpeter. Whereas, for the imita-

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tive output competition of perfect competition, efficiency does require a large number of firms, innovative competition most likely does not. Much innovation has the hallmarks of a race in which the winner takes all. As Demsetz (1995: 139) notes, "The competitive intensity of [such] a contest is not always increased by adding more contestants." What matters is the quality of the contestants and the size of the prize. The existence of patents and other devices to prevent imitative competition—at least for a time—to allow the winners in innovative competition to secure a big payoff for their innovative effort shows that, in a dynamic market economy, there may be many dimensions of competition, with some of the characteristics associated with the different dimensions being inversely correlated—e.g., imitative competition requires a large number of firms, whilst innovative competition requires a small number. Given this reality and the resulting incommensurability of different dimensions of competition relevant for the efficient functioning of a dynamic economy, there can be no single measure—such as market concentration—of competitiveness that can be used to judge the dynamic efficiency of an actual market economy.

Rate-of-Return and Price-Cap Regulations

Nor will rate-of-return or price-cap regulatory formulae necessarily ensure competition. For once there are scale economies, prices can no longer equal marginal costs and there cannot be perfect competition. Competition will not be merely imitative but have some of the elements of a contest, in which some agents will lose and others win. It would be inappropriate to judge the intensity of competition of such a contest by the ex post rate of return of the winner. As Demsetz (1995: 146) notes, "If one were to gauge competitive intensity by the rate of return on investment made by winners in a lottery game, the rate of return would be quite high, but a negative return is obtained if the calculation includes the wagers made by losers." So if one were to use the rate of return criterion to judge the competitiveness of a particular industry, the calculation should ideally also include the costs incurred by those who competed to become incumbents but lost. If, moreover, the decision on incumbency depends on government favors, then the cost would also have to include the rent-seeking costs of all the contestants associated with competing for political favor. That inclusive rate of return need not be above some competitive norm. But, in practice, it will be impossible to calculate.

Natural Monopolies: Regulation or Auctions?

But what of natural monopolies? Surely, once a firm acquires one, it will exploit its monopoly power, and hence such natural monopolies

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will require some form of regulation. Most infrastructural services have elements of natural monopoly. This was the justification used in the past for their nationalization. But, with growing fiscal constraints and the well-known inefficiencies associated with public enterprises, there is a welcome move globally for their privatization. Will this not inevitably lead to these natural monopolies being used by private producers to exploit consumers? Hence, should these utilities not be regulated?

Competition for the Field versus Contestable Markets

The UCLA school of industrial organization has provided a distinctive and important answer to this question, which unfortunately is not as well known as the various dirigiste regulatory regimes currently being touted by mainstream theorists.[5] The basic idea has been labeled "competition for the field" by Harold Demsetz, following a distinction due to Edwin Chadwick in the 19th century between that term and "competition within the field."

Competition for the field differs from the notion of "contestability," insofar as the latter is concerned with competition between an existing incumbent and potential entrants to the natural monopoly. By contrast, competition for the field, as its name suggests, is concerned with the competition for becoming an incumbent in the first place. This distinction has important consequences for the price-output configuration and, hence, for the competitive efficiency of the economy. In the theory of contestable markets it has been shown that, in equilibrium, the only rents the incumbent of a natural monopoly can acquire are the sunk costs that a new entrant would have to incur in moving in and out of the monopoly. If an outsider can enter and exit a market without incurring any transition costs, then the natural monopoly would be perfectly contestable, and despite economies of scale and scope, the incumbent insider would not be able to garner any rents. But, as there are unlikely to be many natural monopolies in which these transition costs are insubstantial, insiders normally would be able to extract rents from consumers equal to these transition costs.[6]

[5]Harold Demsetz (1995: 144, n. 70) notes: "As a small act of institutional immodesty, I note that the profession has allowed the University of Chicago to appropriate to itself the efficiency doctrine of antitrust. The offering of this doctrine in a substantive, analytical way originated at least as much from work done at UCLA as from that done at Chicago." He along with Armen Alchian and Ben Klein have been the leaders of this UCLA school of industrial organization.

[6]I have found this theory particularly useful in thinking of the natural monopoly that is the state. In Lal (1989), I develop a model of the predatory state in which contestability plays a central role. The model is used to explain the rise and fall of empires in India over the millenia.

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The situation is very different from the viewpoint of competition for the field. Here the competition takes place *before* production begins, with would-be natural monopolists competing for the right to serve the market in which each rival could serve the market at the lowest cost, adopting the best technology. In this competition for the field, as Demsetz (1968) showed in his famous essay "Why regulate utilities?," the potential rents of the natural monopoly would be competed away with the best bid amongst the rivals being accepted by the community for becoming the incumbent of the natural monopoly. Thereafter, there would be a distinction between insiders and outsiders, and substantial transition costs for the latter—in sharp contrast with the conclusions of contestability theory. For without these entry barriers, the potential cost reductions associated with scale economies may not be realized by the successful incumbent. The frequency of competition for the field, or equivalently the length of a franchise to the natural monopoly, will depend on the particular supply and demand conditions for the output of the natural monopoly. Also, there is no reason why there should not be contractual conditions attached to the possibility of renegotiation of the terms of the franchise before its expiry. In fact, given uncertainty on this account, the rivals bidding for the franchise will take account of these renegotiation costs in their bids. Similarly, if there are likely to be future cost reductions because of technical progress, which would lead to future rents for the incumbent, these too would be taken into account in the rivals' bids for incumbency if they can be forecast, and the best bid again will involve the whittling away of these potential future rents.

Positive or negative windfalls, which are the result of unavoidable uncertainty, need not be inefficient. For instance, even in nearly perfect markets for commodities, economic agents suffer positive and negative windfalls all the time, but that does not provide a case for regulation. However, in the case of natural monopolies, those windfalls could continue for a considerable period of time. Thus, there could be political pressure for their curtailment if they are positive, and the danger of bankruptcy for the incumbent—and hence a disruption of supply—if they are negative. As such, a case can be made for having a renegotiation clause in any contract granting a franchise to a natural monopoly. What cannot be laid down is some ideal form of contract. For given the ubiqitousness of imperfect information and the associated uncertainty, agents can only search for the best available mutually advantageous contract. In Hayek's felicitous phrase, the market is par excellence "a discovery process."

Game Theory

In contrast with the UCLA view on regulation, the emerging technocratic view on the regulation of natural monopolies is based on the

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frail framework of noncooperative game theory.[7] As the leading game theorists recognize, it is of very limited practical relevance because of the plethora of Nash equilibria that can be generated (Binmore 1990, Kreps 1990). Although of use in training the intellectual muscles of the young, it has not as yet yielded any robust, policy-relevant results in my view.[8]

On Privatizing Infrastructure Services

So how in practice should the current and future provision of infrastructural services in electricity, natural gas, water, sewerage, roads, telecommunications, be dealt with? Though there are some important differences between these different utilities, they have one common feature. The natural monopoly element in their provision consists essentially of the networks they use to ship their products. They provide common transportation facilities for all possible users rather than being dedicated to individual ones.[9] Thus, an electricity grid, a gas pipeline, a system of telephone lines, water and sewage pipelines, railway tracks, and roads are networks. All other aspects of the provision of the services of those utilities can be made competitive by allowing multiple users of these networks to service consumers.

Consider the provision of electricity or gas. There are three stages—production, transmission, and distribution—and there is no reason why the first and last stages should not be competitive. If rival firms are free to produce electricity as they see fit and to service users on the common network, there is no intrinsic reason why the production and distribution of electricity need require regulation.[10]

This leaves the problem of how to handle the transmission stage through the common network. Here there are two choices. First, the network could be communally owned and financed through taxation, but built and run through a franchise given to the bidder who offers to build and supply the network and its services at lowest cost to users. The services of the network would then be available to any user at a fixed fee, or could be free if administrative costs are high.

[7]See, for instance, Gilbert and Newberry (1994), which also has references to this literature.

[8]But see Laffont and Tirole (1993) for an attempt to provide a textbook for the dirigiste technocratic regulator.

[9]See Kay (1994) for this illuminating characterization of the natural monopoly element of utilities. But I do not subscribe to the technocratic regulatory conclusions of his argument.

[10]Recently the notion of "network externalities" has been advanced by Katz and Shapiro (1985), which are claimed to lead to market failure. But most of these—for instance, in computer networks and telecommunications—are examples of pecuniary externalities (Liebowitz and Margolis 1994). But as Buchanan and Stubblebine (1962) pointed out long ago, such pecuniary externalities are Pareto-irrelevant and do not constitute examples of market failure (see Lal 1994: chap. 11).

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That solution, for instance, has been adopted for most public roads in many countries.

Second, the network could be privately financed. Consider electricity. Each regional grid could be set up as an independent private time-bound franchise and then auctioned to the bidder who offers to execute the quantity-quality terms of the franchise at the lowest cost to users during the fixed period the franchise will operate. The bidder who bids most for the existing grid, while meeting the other franchise conditions, would receive the franchise for the stipulated period.

At the end of the franchise there are two options. One is for the grid to return to the community, which then auctions a new franchise for the grid as before. This reversal of the assets in the expanded network to the community is very much the practice—for example, China has adopted it in its foreign direct investment projects.

The other alternative is for the incumbent of the grid to obtain the highest price anyone is willing to pay for the grid, subject to the new price-quality and expansion conditions. Of course the incumbent would also be able to participate in the bidding procedure.

There are three reasons to favor this latter alternative rather than have the networks's capitalized value revert to the community at the end of the franchise. The first reason is that, in the second form of contract where the incumbent recoups the capitalized value of the grid from the highest bidder for the new franchise, the price charged to users of the network and the price to final consumers will be lower than with the first option where the grid reverts back to the community. Of course, what consumers gain through lower prices, they lose through the loss of tax revenue that would accrue if the grid reverted back to the community. But if, for reasons of what may cryptically be called political economy, the social value of a dollar of tax revenue is less than one dollar, consumers may be better off getting their dissipation of the potential rents from the natural monopoly through a reduction in prices than through the government budget.

The second reason for preferring the option where the incumbent "sells off" the grid to the highest bidder after the end of his franchise is that this reduces the time inconsistency in his investment decisions that could arise with the first option of the grid reverting to the community. In this latter case, the incumbent would have an incentive to underinvest in both maintenance and expansion toward the end of his incumbency, and thus run down the assets of the natural monopoly. This problem would be avoided if he could obtain the capitalized value at the end of his incumbency of the assets he bought, maintained and created during his franchise.

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Finally, as the incumbent will usually be a private firm, the trading of its shares on the stock market would permit takeovers by other private firms, which could prevent any monopoly developing on the networks even during the franchise period as has so often happened under regulation.

The same scheme would be applicable for the transmission of electricity at the intra-regional or local level. Intra-regional or local franchises would be set up and auctioned on the same principle as the regional grid.

With any user of the network having access to it at the fixed fee determined in the auction for the network, any company could set itself up without any government regulation to sell electricity to consumers. With the generation of power privatized, these distributing companies would be able to purchase electricity from the cheapest source given the varying demands for power. In fact, as has happened in Great Britain, a spot market for delivery of power by competing generators would develop. These generators could also end up specializing, with some finding it profitable to provide base-load and others peak-load power. There would be no need for government intervention of any sort in either the production or distribution of power.

Similar schemes can be set up for all the other infrastructural services, which do not therefore need to be funded from tax revenues. This solution would also prevent the regulatory jungle and rent-seeking that the botched privatization of utilities in Great Britain has promoted (see Robinson 1993, Beesley 1994).

Finally, it may be noted that in many countries the contracting out of the provision of many local public services—e.g., garbage collection—which was pioneered in Great Britain is now growing.

Conclusion

Professor Shenoy's was a lonely but eloquent voice pointing out the folly of planning in India. He was opposed by a clerisy claiming access to the latest technocratic thinking. They prevailed. But their prescriptions made it impossible to fulfill the pledge Nehru made in his famous "tryst with destiny" speech at Independence: "to wipe every tear from every eye." Thirty years after Shenoy's effective vindication—as India, however belatedly, moves from the plan to the market—another form of dirigisme promoted by the current technocratic "best and the brightest" could once again blight the prospects of fulfilling this pledge.

In this article, I have attempted to show that first, as before, with so much contemporary theory, in Peter Bauer's sage words, "The

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emperor's new clothes are of the finest hue but there is no emperor within." Second, that, as regards the problem of natural monopolies in the provision of infrastructural services, there are simple ways to avoid the new dirigisme of regulation which, as in the past, the Siren voices of the clerisy are promoting. In this sense, I hope I have provided a fitting memorial to a great classical-liberal economist and a great Indian who showed uncommon wisdom and courage, and whose only fault was not to be in tune with his times.

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The Transformation of Hearts and Minds in Eastern Europe

Vojtěch Cepl

The process of transformation in Eastern Europe is not a subject conducive to brief and simple treatment, as the experience of the many countries in this region has varied to a considerable degree. Thus, I shall focus almost exclusively on the experience in Czechoslovakia and the Czech Republic to illustrate the key factors or components in the transformation process. In addition to the fact that my experience of the process is tied to my home country, I choose to focus on it for another reason. It is my opinion that the process of transformation in the Czech Republic has in some ways gone further than in other countries.

I am, of course, mindful of the different historical conditions in the various countries. For example, in Hungary the replacement of the communist regime took place more slowly and organically, and in Poland people put up greater resistance to communist instrusions from the beginning—they never surrendered agricultural land to nationalization or allowed the Catholic Church to be entirely suppressed. Those factors might also account for the difference in the transformation process.

The Czech Republic has taken certain routes that other countries either have not taken or have not taken so completely, particularly in the critical areas of condemnation of communist crimes, lustration, and restitution. I shall not consider East Germany because its experience of being directly incorporated into a fully developed western democratic nation is unique and not comparable to that of other countries. In some respects, however, the Germans did travel along the same route as Czechoslovakia.

After the overthrow of communist regimes in 1989, Ralf Dahrendorf commented very presciently: "It will take six months to reform the

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political systems, six years to change the economic systems, and sixty years to effect a revolution in the peoples' hearts and minds." In this essay, I will deal with the third aspect of the transformation, which is similar to Michael Novak's concept of moral culture, referring to it either as hearts and minds, the rules of human conduct, or the peoples' values. I can state my point about transformation of the moral culture very simply and succinctly: without condemnation, lustration, and restitution there can be no transformation. This is the heart of the matter. I will elaborate on this idea, explaining what I mean and why I believe this is the case.

Metamorphosis of the Rules of Human Conduct

The slowest, most complex, most elusive, but in my view most crucial part of any process of transformation is the necessary metamorphosis of the rules of human conduct. The rules of human conduct consist of the very concrete norms that exist in the minds of the people and are the basis for their day-to-day behavior patterns and their shared values. These rules and norms inform their thought as to what is right and wrong, proper and improper, appropriate and inappropriate in particular situations, or even what they must do to get by in life. In this way, they know when they are bound to keep their promises, when it is appropriate to ignore a legally prescribed rule or to bribe an official, when a person's conduct amounts to a provocation, and so on.

Knowledge of these rules is not gained from the study of law, rather it is garnered by life experience within a society. They are what is foremost in peoples' minds, not the intricate theoretical principles of how an independent judiciary will protect their freedoms or how a second chamber of parliament will operate as an effective corrective to the dangers of abuse of power by the first chamber. These informal rules are the norms of conduct and shared values that actually operate in everyday life to effect patterns of behavior in society. Formalistic declarations about freedoms and democratic principles that are ignored in practice never enter into this realm.

These norms develop and are internalized gradually in an evolutionary fashion; they cannot change overnight. They change only when there is a real difference in the rules of the game in actual life, and for some people they can never change because habits can be difficult to break. Another factor that works as an obstruction to these changes is the length of time the previous rules were in effect. Nazi Germany introduced extreme changes in these norms, but it lasted only 12 years so that they had not become so deeply ingrained, and the better norms that had existed prior to the regime were still in most peoples'

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memory. Eastern Europe had communist regimes in place for two generations, so that the core of the population under 50 never experienced any other societal norms. Fortunately, those over 50 had, and there was a democratic tradition in some countries to fall back on.

The nations in the former Soviet Union, with the exception of the Baltic States, have the most daunting challenge of all because they had 75 years of communism and absolutely no prior tradition of a free society. This difference makes their situation different in kind so that it is simply incomparable. In any transformation, there is only a certain amount of time to effect changes before people wish to settle back down to a normal existence. So paradoxically the slow pace of change for these rules of conduct works against any sort of transformation.

The rules of human conduct are the most difficult to transform because there is the tremendous force of inertia to contend with. Political and legal changes can be modeled on the systems of western democracies; the communist regimes did that to a large extent. In contrast, rules of human conduct are learned by observing societal conduct and are not changed by amendments to legal texts but only by people actually modifying their behavior. In this way, a dissonance between the abstract principles of law and constitutional government introduced since 1989 and peoples' actual conduct has developed. These principles must be infused over time into the actual life of society.

Ritual Purification: Changing the Moral Culture

A few years back, I wrote an article entitled "Ritual Sacrifices" (Cepl 1994). In hindsight, I would change that title because it suggests scapegoating or making innocent people pay the price for something they are not guilty of. It also, to a certain extent, suggests revenge. But if revenge had been our motivation, there are more effective ways of going about it that inflict a far greater sanction than symbolic acts of condemnation, lustration, and restitution.

In place of the title "Ritual Sacrifices," I would now substitute the title "Ritual Purification." That term expresses the outdated notion that, if some evil is introduced into the body politic, whether by usurpers of power or by legitimate leaders acting immorally, order in the moral universe is somehow deranged, and the effects of this are felt even in the natural world (crop failures, pestilence, bad weather). As this idea is seen in the plays of Sophocles and Shakespeare, the proper balance is only reestablished by removing the wrongdoers, punishing them, and reestablishing the status quo ante. I admit that

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this idea is outdated, but there is something to it nonetheless. Personally, I do not believe in the moral order as a separate and independently existing part of reality. If it exists at all, it is as a part of the norms of human conduct and human values I am discussing, and the reestablishment of a normal situation in society is closely related to the task of healing the rift between the government and the people who are alienated from it. As I have said, this is done in part by repudiating the past—by symbolic acts of parliament condemning communism, by lustration, and by restitution.

Condemning Communism

In July 1993, the Czech Republic passed the "Act on the Lawlessness of the Communist Regime," which condemned the communist government, its actions, and the principles that motivated it. It was a simple and powerful repudiation of the past, leaving no room for compromise. Such a simple declaration of values is far more effective than any detailed and precisely worded legal provisions in a statute, and it speaks more directly to the people. Moreover, such a declaration helps to establish an important connection between the peoples' values and the abstract principles expressed in the constitution. People develop an allegiance to constitutional and legal principles when they better understand that the principles of legality and the rule of law are part of their own values. This "ritual purification" of the past means that such ideas and values as ruled during the communist regime have been definitively condemned and banished. The people can see the body politic as cleansed.

Lustration

Lustration has a similar significance, but one more closely related to reality because the government is actually cleansed of personnel who cannot be trusted to hold power. As a result, the people feel more confidence that their leaders are not merely mouthing democratic ideas while surreptitiously undermining the foundations of democracy.

Restitution

The value of restitution is that the government is rectifying its past misdeeds, that is, it is returning what it stole from the people. Restitution involves the return of the actual piece of property confiscated from people without compensation, or which people forfeited as the result of one of the communist laws. In addition, coupon privatization has an element of restitution because the industrial wealth that was distributed in that process was considered as representing

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in the abstract the fruit of the peoples' labor of which they had been deprived for decades. While the government acknowledged from the start that not all past injustices could be rectified (hence, the limitations on the return of property), the important thing is that it showed itself willing to acknowledge past wrongs and to do its best to correct them. If it had made no effort in that direction, it would have confirmed what the communist regime had done, losing a great deal of credibility in the people's minds both for itself and for democratic principles. In addition, restitution, as well as other privatization routes, greatly contributed to psychological changes in the people, as it made most of them into small property-holders and capitalists.

The Practical Motivation for Condemnation, Lustration, and Restitution

In addition to serving a general symbolic or psychological function in reestablishing a normal relation between the people and the government, parliamentary acts condemning the communist regime, lustration, and restitution have specific and practical purposes. The condemnation of the communist regime, as well as the punishment of crimes committed under it, help prevent people from claiming at some time in the future that communist principles are somehow compatible with democracy and that communism was not really so bad. The punishment of crimes committed under communism helps deter the possible repetition of such outrageous behavior in the future.

In the case of lustration, the object was to exclude known communists from holding political office because they cannot be trusted to exercise it consistently with democratic principles. Lustration also gives democracy a breathing space, a period of time during which it can lay down roots without the danger that people in high positions of power will try to undermine it (keeping in mind that these people are usually more experienced and organized in the arts of governing and using power). Any fundamental change in a society is, and must be, accompanied by a replacement of the ruling elite. Criticisms of this natural process as McCarthyite, and as offending the principles of legal certainty and stability, are often made by friends of the old order.

As for restitution, the practical motivation for it was to jump start the economy by placing property into the hands of citizens so that they could immediately become private economic actors. There were several privatization methods, and in our experience, restitution was the most natural, simple, and quickest of all of them, and it was the one most comprehensible to the people. The collapse of the judicial

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system due to a flood of lawsuits over restitution did not occur, and in fact, the process was relatively dispute free.

Conclusion

The most elusive, invisible part of transformation, the change of the moral culture, is usually considered as quite secondary, if it is thought about at all. People who say it is better to draw a line and start everything from scratch have not learned the proper lessons from the dearly purchased experience of the communist era.

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The Spirit of Humility

Stanley Kober

The American Experiment

When the American Constitution was being signed at the conclusion of the Constitutional Convention, Benjamin Franklin remarked that he had often wondered whether the rays of the sun painted in the chair of the president of the convention signified a sunrise or sunset for the new country. According to James Madison, Franklin expressed his satisfaction that "now at length I have the happiness to know that it is a rising and not a setting Sun."[1]

The Constitutional Convention was an extraordinary experiment, an attempt to determine, as Alexander Hamilton put it in *Federalist* No. 1, "whether societies of men are really capable or not of establishing good government from reflection and choice, or whether they are forever destined to depend for their political constitutions on accident and force." This is the challenge that today confronts the newly emerging democracies.

If the American experiment may be regarded as successful, if it is a model to be emulated, the reason must be found in the causes of the American Revolution. "The Revolution was effected before the war commenced," John Adams observed. "The Revolution was in the minds and hearts of the people; a change in their religious sentiments, their duties and obligations. This radical change in the principles, opinions, sentiments and affections of the people, was the real American Revolution."[2]

Of all these changes, perhaps the most important was what historian Daniel Boorstin has called "the courage to doubt," which was exemplified by Benjamin Franklin. Near death, Franklin was asked his opinion

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[1]Quoted in Farrand (1966, vol. 2: 648).

[2]Letter to Hazekiah Niles, 15 February 1818, quoted in Seldes (1985: 7).

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about a religious question. He expressed an opinion, but added that "it is a question that I do not dogmatize upon, having never studied it, and think it needless to busy myself with it now, when I expect soon an opportunity of knowing the truth with less trouble."[3] Franklin was not troubled by living in a state of uncertainty regarding a question for which he had no good evidence one way or the other. Since a decision was not required, he was content to wait until better evidence became available.

The United States was built on this foundation of healthy doubt, which is expressed in American institutions. Indeed, the peaceful transfer of power depends on it. In a democracy, the minority cedes power to the majority on the assumption that the majority has a better claim to be in the right. The minority does not conclude that it must be wrong; rather, it acknowledges, in effect, that it might be wrong. Just as important, the majority makes the same assumption, for otherwise it would not allow itself to be turned out of power merely for losing an election.

Civil Society and the Limits of Knowledge

This system of government, which is the political expression of civil society, is therefore grounded in a spirit of humility that recognizes the limits of our knowledge. That spirit is also the spirit of modern science, but it was not always this way. In the *Novum Organum*, written in 1620, Francis Bacon defined empirical inquiry as an effort "to seek, not pretty and probable conjectures, but certain and demonstrable knowledge."[4] It was this definition of science as a superior way to certain truth that led Karl Marx to call his version of socialism an improvement on prior interpretations, and which led to the tragedy that followed when his ideas were put into practice.

Modern science takes a different view. In the words of Karl Popper (1969: 115), "Scientific theories . . . are genuine conjectures—highly informative guesses about the world which although not verifiable (i.e., capable of being shown to be true) can be submitted to severe critical tests." This more humble approach to the possibilities of science is also enshrined in Heisenberg's principle of uncertainty, which Jacob Bronowski renamed the principle of tolerance. "Science has progressed," he explained, "because it has understood that the exchange of information . . . can only take place with a certain toler-

[3]Quoted in Boorstin (1987: 179).

[4]Excerpted in Commins and Linscott (1947: 77).

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ance" (Bronowski 1973: 365). And what holds true for science is equally true for all other fields of human endeavor.

This recognition of the limits of our knowledge has two implications for civil society. First, it means that government must also be limited. According to the American Founders, democracy did not mean the election of a government that had total power. On the contrary, they were very conscious of the dangers of the tyranny of the majority. In particular, they were hostile to the idea of concentrating power in a single individual, even if elected. As James Madison warned the Constitutional Convention, the United States had to avoid "the Evils of elective Monarchies."[5]

Second, it signifies that if the majority will is determined by anything other than a public opinion capable of changing, civil society is in trouble. This was the principle for which the United States fought its civil war. As Abraham Lincoln explained in his first inaugural address:

> A majority, held in restraint by constitutional checks, and limitations, and always changing easily, with deliberate changes of popular opinions and sentiments, is the only true sovereign of a free people. Whoever rejects it, does, of necessity, fly to anarchy or to despotism.[6]

This principle was also identified by Thomas Masaryk as an indispensable characteristic of civil society. "Freedom of opinion is a form of political freedom, and a condition of it," he wrote. "Criticism is at once a postulate and a method of democratic policy just as it is a postulate and method of science and of the scientific spirit." And such criticism must lead to change in public opinion and public policy. "Life is change, constant change, constant growth," Masaryk celebrated. "An active people will make living organizations, new and ever new in the State and in society" (Masaryk 1927: 400, 401, 415).

Change, however, can also be unsettling, and people unaccustomed to it frequently look for something certain to cling to. "A person who was accustomed for many years to living under rigorous rules that prevented him from making his own decisions suffers from a kind of shock," President Václav Havel has explained. "They find themselves in a state of uncertainty, in which they tend to look for pseudo-certainties. One of those might be submerging themselves in a crowd, a community, and defining themselves in contrast to other communities."[7]

Individual Sovereignty and the State

Havel has put his finger on the central question confronting us. We are all in favor of self-determination, which means that we all

[5]Quoted in Farrand (1966, vol. 1: 70).

[6]*Abraham Lincoln: Speeches and Writings* (1989: 220).

[7]Quoted in Kamm (1993: A11).

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want the right to participate equally in the affairs of government and to enjoy the equal protection of the laws. Unfortunately, self-determination has come to mean the self-determination of a group, typically the nation, which leads, as Havel has warned, to the subordination of the individual within the group. "I am in favor of a political system based on the citizen, and recognizing all his fundamental civil and human rights in their universal validity, and equally applied," he has written. "The sovereignty of the community, the region, the nation, the state—any higher sovereignty, in fact—makes sense only if it is derived from the one genuine sovereignty, that is, from human sovereignty, which finds its political expression in civic sovereignty" (Havel 1991: 49).

Havel has expressed one of the great principles of the American Constitution, which begins: "We the People of the United States . . . do ordain and establish this Constitution." Those famous words, as Alexander Hamilton emphasized in *Federalist* No. 15, were not accidental, but an intentional departure from the earlier Articles of Confederation. "The great radical vice in the construction of the existing Confederation is in the principle of LEGISLATION for STATES or GOVERNMENTS, in their CORPORATE or COLLECTIVE CAPACITIES, and as contradistinguished from the INDIVIDUALS of whom they consist." In contrast to the Articles, in which the sovereign states formed the United States, it was the sovereign people who created the United States under the Constitution. And the people were sovereign in their individual, not collective, capacities. "Legislation for communities, as contradistinguished from individuals," Hamilton wrote with Madison in *Federalist* No. 20, "is subversive of the order and ends of civil polity."[8]

The danger, of course, is that if a state is based on any other principle, its majority will be determined not by the freely changing flow of public opinion, but by a permanent characteristic, such as nationality or religion. This relationship of permanent majority and permanent minority is an unstable foundation for a democracy. In the first place, as the history of Lebanon has demonstrated, these relationships may not be as permanent as people believe. Lebanon suffered through a bloody civil war because a framework of government that assumed a permanent Christian majority could not peacefully adjust to the shift in the population.

Second, the relationship of permanent majority to permanent minority suggests that the minority enjoys its rights at the sufferance of the majority, and consequently never feels truly secure or an integral

[8]For more on this theme, see Kober (1993: 70–73).

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part of the state. The breakup of Yugoslavia is an illustration of the outcome of such sentiments. Reassurances by the majority of respect for minority rights were simply not believed. As the Yugoslav academic Vladimir Gligorov has asked rhetorically, "Why should we be a minority in your state, when you can be a minority in our state?" When enough people ask this question, "the ultimate consequence is . . . not to have a state at all" (Gligorov 1994: 158).

Universal Human Rights

For democratic government to endure, therefore, it must be based on a universal conception of human rights. This was the spirit of the American Declaration of Independence, as Lincoln observed in his response to the Supreme Court's decision in the *Dred Scott* case, in which the Court decided that slaves could not be considered equal to other human beings. Lincoln replied that the words of the Declaration could not be confined to the white inhabitants of the United States, but had a universal application. The Declaration, he insisted,

> meant to set up a standard maxim for free society, which should be familiar to all, and revered by all; constantly looked to, constantly labored for, and even though never perfectly attained, constantly approximated, and thereby constantly spreading and deepening its influence, and augmenting the happiness and value of life to all people of all colors everywhere.[9]

Or as George Washington put it in his extraordinary letter to the Hebrew Congregation in Newport, Rhode Island:

> The Citizens of the United States of America have a right to applaud themselves for having given to mankind examples of an enlarged and liberal policy: a policy worthy of imitation. All possess alike liberty of conscience and immunities of citizenship. It is now no more that toleration is spoken of, as if it was by the indulgence of one class of people, that another enjoyed the exercise of their inherent natural rights.[10]

Washington's words signify the transformation of the focus of government from the divine right of kings to the divine rights of the people. And those rights are universal. Although Washington's patriotism as an American was unimpeachable, he did not identify himself in contradiction to other peoples, but considered himself "a Citizen of the great republic of humanity at large." As he explained in a letter to Lafayette:

[9]*Abraham Lincoln: Speeches and Writings* (1989: 398).
[10]Reprinted in Padover (1973: 159).

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> I cannot avoid reflecting with pleasure on the probable influence that commerce may hereafter have on human manners and society in general. On these occasions I consider how mankind may be connected like one great family in fraternal ties. I indulge a fond, perhaps an enthusiastic idea . . . that the period is not very remote, when the benefits of a liberal and free commerce will, pretty generally, succeed to the devastations and horrors of war.[11]

Free Trade: A Foundation of Civil Society

Washington's words remind us that free trade was one of the original foundations for civil society. As David A.J. Richards (1989: 56–7) has noted, Adam Ferguson, in *An Essay on the History of Civil Society* (1767),

> observed that "to the ancient Greek, or the Roman, the individual was nothing, and the public everything," an attitude expressed by disdain for commerce and by devotion to classical republican civic virtue and to war as the main business of public life; in contrast to such "rude" societies, "civilized" or "polished" societies were marked by commerce and the division of labor and the inequalities that arose from differential rewards for different talents and occupations.

Civil society, in other words, is a commercial society, which is another way of saying it is a trading society, in which people earn their living by providing goods and services that other people want, both in their own country and abroad. The money they earn is theirs to do with as they see fit, and any taxation must be approved by them through their elected representatives. This fundamental principle of the American Revolution reflects Ferguson's insight, for societies based on the principle that the money people earn belongs to the state, can be taken from them without their consent or even knowledge, are states biased toward excessive military spending and war. If there was any doubt about this proposition, the collapse of the Soviet economy should have put an end to it.

But as Ferguson also pointed out, war has been one of the forces behind the creation of civil society. "Without the rivalship of nations, and the practice of war, civil society itself could scarcely have found an object, or a form," he observed. "It is vain to expect that we can give to the multitude of a people a sense of union among themselves, without admitting hostility to those who oppose them."[12]

[11]In Allen (1988: 326).

[12]Excerpted in Gay (1973: 562–3).

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Europe's Challenge

Can a people have a sense of union without identifying an enemy? That is the challenge facing Europe as it attempts to unite its eastern and western halves in the aftermath of wars both hot and cold. "The greatness of the idea of European integration on democratic foundations consists in its capacity to overcome the old Herderian idea of the nation state as the highest expression of national life," President Havel has explained. "The greatness of this idea lies in its power to smother the demons of nationalism, the instigators of modern wars" (Havel 1993: 3).

If civil society is to be placed on a new basis, on a foundation that is truly civil, it must be grounded in the spirit of humility that grows out of the recognition of the unavoidable limitations on our knowledge. In the words of one of America's greatest jurists, Learned Hand (1960: 190), "The spirit of liberty is the spirit which is not too sure that it is right." When that spirit is abandoned, tragedy results. "When people believe that they have absolute knowledge, with no test in reality, this is how they behave," Bronowski emphasized in describing Auschwitz. "This is what men do when they aspire to the knowledge of gods" (Bronowski 1973: 374). And what they have done before, they can do again. As the tragedy of Yugoslavia demonstrates, the sun has not set on evil in this new dawn for Europe.

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